NICOLA WEALTH MANAGEMENT

TAX REFORM 2017

By John Nicola, CFP, CLU, CHFC

> "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."

JEAN-BAPTISTE COLBERT

Jean-Baptiste Colbert was the finance minister for Louis the XIV, whose penchant for spending money he did not have is, perhaps, only rivalled by our current government in Ottawa. The quote at left has become famous for its cynical summary of how taxation should work without causing the populace to revolt.

Another similar view was expressed eloquently by Will Rogers. If I may paraphrase: "The only difference between death and taxes is that death does not get worse every time Parliament meets."

Last month, the Department of Finance released a detailed white paper proposing the most significant reform of the tax system for private corporations in Canada since the Carter Commission of 1968. By now many, if not most of you, have received a summary of this paper from your tax advisors.

Our purpose in commenting on this proposed legislation is to:

1. Help you understand the proposed rules and the overarching philosophy behind them.
2. Clearly communicate the impact these new rules may have on us and our clients.
3. Focus on planning models that allow for the most tax-efficient ways to build and manage wealth.
4. Consider the best way to communicate with our MPs and the government with respect to changes that we feel should be made.

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My sense is that the Liberal government is looking at taxation as way of leveling the playing field and ensuring that the "1%" increases their net financial contribution to society. There is much evidence to suggest that global wealth and incomes have become more concentrated within the 1%, but, interestingly, Canada has a higher level of upward mobility and lower level of inequality than the US, UK, Italy, Spain, Japan, Australia, New Zealand, and France (as shown below in the charts provided by the Bank Credit Analyst).

Perhaps it begs the question, are they trying to fix a problem that does not exist?

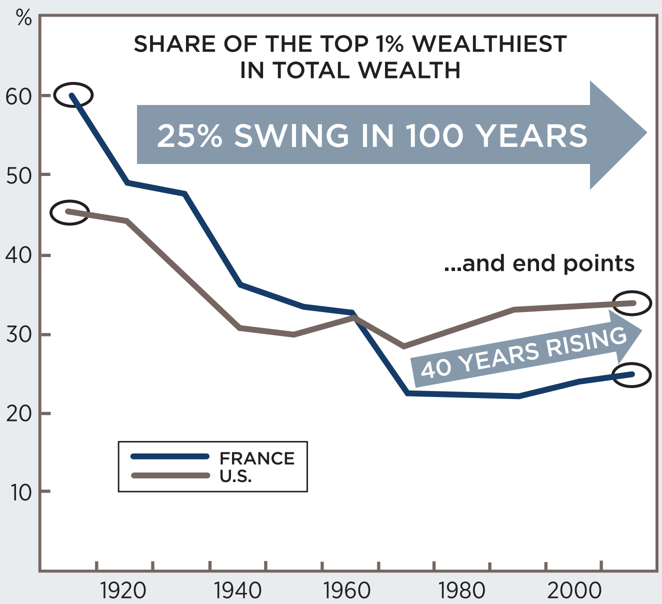
In addition, these proposals cover *all* private corporations – they are not targeted at the wealthy and could have unintended consequences. Any middle-class entrepreneur who carries on business through a private corporation will be affected by this change.

The core of the issue is the difference in risk that an entrepreneur has versus an employee in a company (large or small) or within the government. Considering the burden business owners take on, the tax system should be designed to reward said risk, because it creates jobs, growth, and supports a system that allows for transfer of business to the next generation.

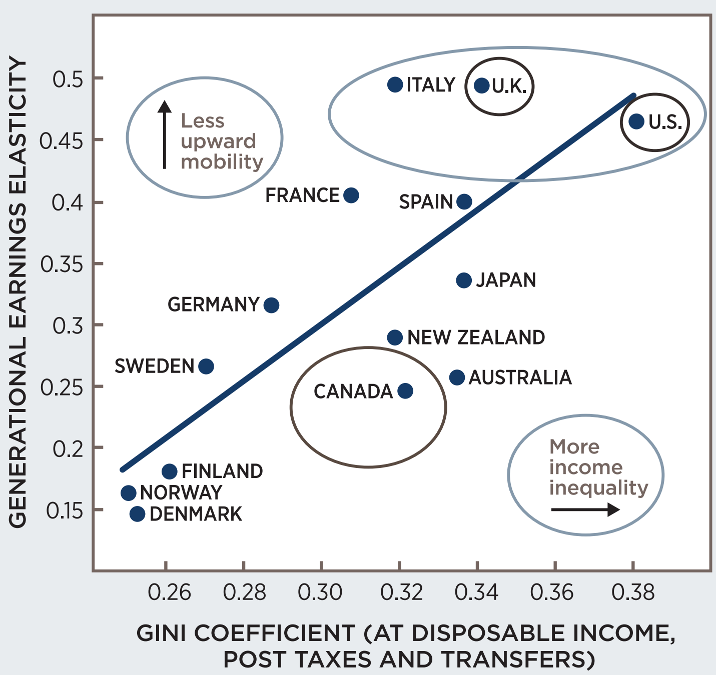
Nevertheless, the tax advisors we spoke with feel that the government is very serious about their white paper and have kept the consultation period very short (75 days) in order to ensure that all changes can be in effect on January 1, 2018.

THE END OF THE ANGLO-SAXON ECONOMY?

U.S. and Europe: Different Starting Points of Inequality



Opportunity and Income: Anglo-Saxons are Outliers



BELOW IS A VERY BRIEF OUTLINE OF THE MAJOR CHANGES BEING RECOMMENDED – THIS IS A SHORT SUMMARY OF SOME VERY COMPLEX PROPOSALS; IT'S NOT THE LAST WORD.

1. **Eliminate the ability** for incorporated professionals and business owners to income split with family members (except where specific contributions to the operations of the business can be shown to exist).
2. **The tax on passive income** earned within corporations will still be 50%, but the system of refundable tax credits *(Refundable Dividend Tax On Hand, or RDTOH)* and tax-free distributable capital gains *(Capital Dividend Account, or CDA)* would be eliminated for income earned from 2018 onward. The consequence of this could be a combined personal and corporate tax rate of 70% or more on this type of income.
3. **There are other changes** that are focused on strategies that convert taxable dividends to capital gains and that multiply the capital gains exemption, but few of our clients have used these approaches in their overall tax planning.

The first two changes are the ones that will affect most of our clients. While we won't likely see any formal legislation until the end of 2017, we can still examine what types of planning should be considered if the final legislation matches the current white paper. For now, in terms of planning, the best advice we have received is to wait until the consultation period is over and the ratified legislation is delivered.

There may be some exceptions to this advice noted below.

Some considerations that require a different approach are:

- Ideally, if the legislation is formalized, one would have minimal or no net taxable income of passive assets in a private company.
- Income splitting using dividends with family members will be significantly curtailed and for some clients eliminated (because the tax cost will be too high). Therefore, other income splitting approaches should be considered. There is an argument for being prepared for this different approach well before the end of 2017.

HERE IS OUR INITIAL SHORT LIST OF POTENTIAL PLANNING STRATEGIES THAT MAY WORK WELL IF TAX REFORM IS ENACTED.

1. **Maximize the use of Individual Pension Plans (IPPs)** as vehicles to accumulate retirement assets on a tax-deferred basis. An IPP is similar to an RRSP, but with higher contribution limits that are tax deductible to the company.
2. **Consider the use of a Retirement Compensation Arrangement (RCA)** as a supplement to an IPP, effectively creating even more tax deductible pension contributions.
3. **Reduce taxable passive income inside a corporation** with better asset allocation (no or reduced fixed income, higher allocation to assets such as real estate that earn return of capital, and capital gains or eligible dividends; best if assets are held for longer term and not frequently traded). Over the last five years we have been able to keep the annual taxable portion of most corporate accounts to less than 3% of capital on an annual basis. The average return over that period of time for these accounts was just over 8%, so less than 50% of the total return has been taxable.

   If, as an example, one has a corporate portfolio with $2M of capital, then about $60,000 or less of the total annual return of $160,000 is taxable. At 50%, the current annual tax would be $30,000, or 1.5% of the capital.
4. **On the other hand, it may make sense to trigger deferred capital gains** on corporate assets before the end of 2017 to maximize the ability to add to RDTOH and CDA balances within a private corporation. If one waits to trigger gains beyond 2017, they may be subject to much higher tax rates in the future.

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5. **Based on what we know so far, it appears that there will be double taxation on dividends paid from a holding company.** Using the previous example of a company paying about 50% tax on taxable income; when a dividend is paid, the additional personal tax in B.C. is between 30-40% combined; this reaches a tax rate approaching 70%. Based on this, there may be better ways to get taxable investment earnings from a holding company, including:
   - Pay out profits earned as reasonable taxable bonuses to shareholders, as opposed to dividends.
   - Make charitable donations or gifts to a foundation or donor advised funds from taxable corporate income (e.g., donation to one's NWM Private Giving Foundation) as corporate donations are fully tax deductible.
6. **At this time, life insurance remains tax exempt and is still tax free at death.** It continues to offer significant benefits in both accumulating tax-deferred safe capital corporately and in reducing tax liabilities within estates. There may be some very attractive opportunities to increase the use of insurance with prudent leverage to grow tax-free earnings within a corporation while creating a tax-deductible interest expense to reduce taxable income on other assets.

At the moment, we have at least as many questions as we have answers. That uncertainty is likely to continue for several months. Nevertheless, it makes sense to be proactive. Please speak to your NWM Advisory Team to ensure you have a plan in place before the end of 2017 to best manage the impact of these new rules.

As more information comes out we will communicate with you, and when a particular planning approach proves to be clearly effective, we will recommend it where it applies to your situation.

In the meantime, consider getting involved in the following ways:

- **If you are a member of a professional organization or business group,** then find out what they are planning to do with respect to these proposals. As far as we can tell, most groups that represent self-employed individuals are opposed to much, if not all, of this tax reform.
- **Write to your MP with your concerns.** This legislation assumes it is necessary to level the playing field by specifically taxing self-employed professionals and business owners at much higher rates even though they take the highest risks within society in terms of their work and establishing their enterprises. They also employ almost 50% of the Canadian workforce. This group of individuals typically has no guaranteed income, tenure, pensions, or employment insurance (including maternity leave benefits), and often personally guarantees any debt related to their business or profession. Neither the politicians who have proposed these rules, nor the officials in the Department of Finance that drafted them, face these risks.

This is a time to be proactive from both a planning and political perspective. Legend has it that the English expression "may you live in interesting times" is a translation of a Chinese curse.

When it comes to taxation in Canada, 2017 has already proved to be "interesting" and the year is barely half over.

There is more to come.

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