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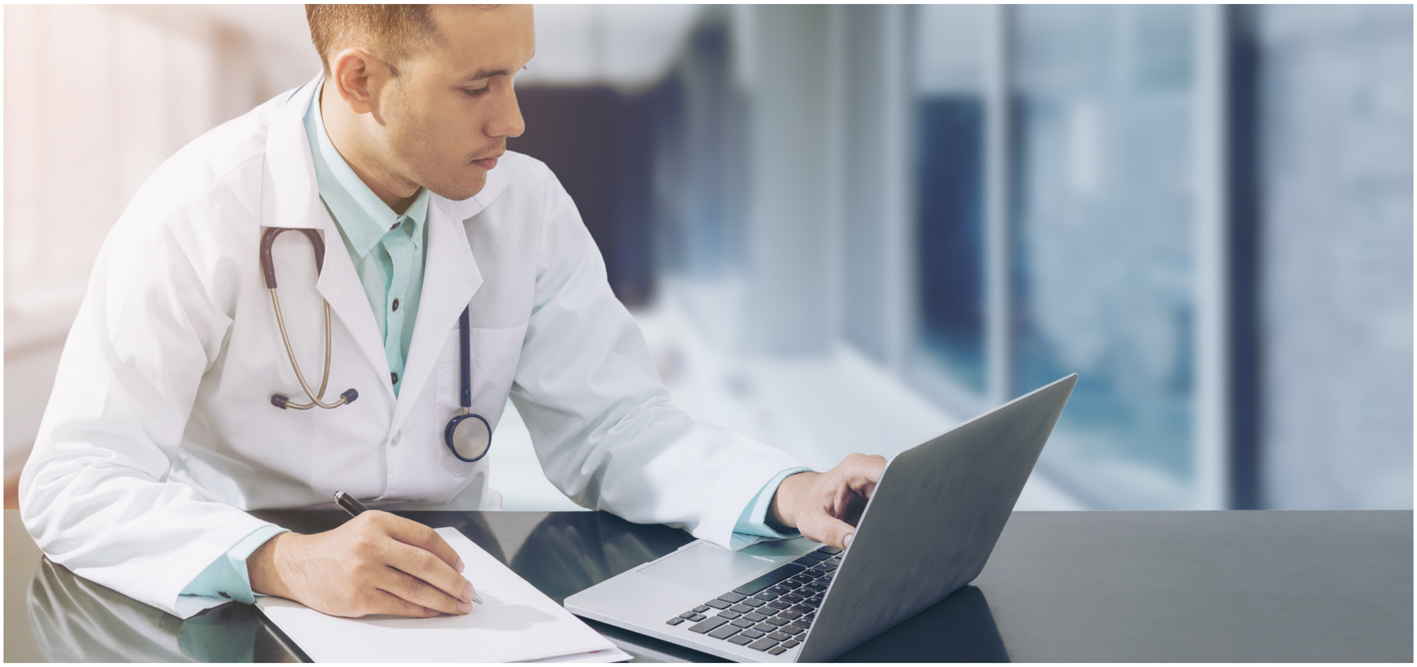
WealthHealth

A Monthly Financial Service Specifically for Physicians



New Tax Rules Affect Passive Investment Income in Your Professional Corporation

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WHAT'S HAPPENING STARTING JANUARY 1, 2019

The February 2018 federal budget clarified the rules around passive income for Canadian-controlled private corporations (CCPCs) and introduced a *$50,000 threshold for passive, taxable income within a year.* The threshold is effective for the 2019 tax year and applies to all physician corporations.

The threshold, or cap, also affects the small business deduction. Your corporation must keep passive income to $50,000 or less if you want to access the full $500,000 small business deduction limit. If not, the limit is reduced *$5 for every $1 of investment income that's over $50,000.* This could be a major issue for you that requires proper management.

Right now, the small business tax rate is about 13.5% on the first $500,000 of active business income, and about 26.5% on amounts higher. Under the new rules, income subject to the small business tax rate will be reduced when *passive investment income is more than $50,000 per year.* This means a company earning $150,000 of passive income would have no access to the small business tax rate and would pay the general income rate (26.5% to 31%) on all active business income. Note, it's not passive income but rather taxable passive income that counts.

CURRENT RULES	NEW RULES (January 1, 2019)
First $500,000 of business income taxed at 13.5% **Tax = $67,500**	Assuming corporate investments earn $150,000 per year, the corporate tax rate is 26.5% **Tax = $132,500**
Difference = $65,000 increase in tax	

Note: Numbers and percentages are for example only; tax rates vary by province.

It takes a specialized and experienced advisor to properly ensure your plan integrates advice and solutions from the applicable professionals; this includes coordinating your wealth management and risk planning with your tax situation.

If you continue to exceed the threshold in passive investments (mutual funds, stocks or bonds, rentals, etc.), this strategy could cost you up to $65,000 per year in additional tax and over the long term, it could cost you millions.

What's the significance of the $50,000 number to Canada Revenue Agency? The cap is equivalent to the government's estimate that it represents about $1 million of passive investment assets, assuming a 5% return. The number aims to provide some flexibility for small business owners to save for a variety of purposes – sick leave, parental leave, an economic downtown or retirement.

WHAT'S IN AND WHAT'S NOT

What counts as passive investment income?

- Real estate rental income
- Canadian and foreign dividends
- Interest from investments
- Interest from short-term bank deposits used for business operational purposes
- The taxable portion (50%) of capital gains from investments. Net capital losses from previous taxation years are excluded.
- Income from savings in a life insurance policy that's not tax exempt; for example, annuity payments and allocations from segregated funds.

What does NOT count?

- Realized capital gains from an asset used for your business (for example, if you own the building that houses your practice and you make money when you sell it)
- Realized capital gains from selling shares in another corporation that's connected to your corporation where all, or almost all, of the assets are from an active business
- Growth in life insurance polices that are structured to be tax exempt. The policy (usually participating life or universal life) must have an investment component.

PASSIVE INCOME TREATMENT OF ASSETS

Asset type	Tax treatment in a CCPC
Canadian equities	• Dividends: 38.3% • Realized capital gains: 25% • Current tax on deferred gains: 0%
Foreign equities	• Dividends: 50% • Otherwise, same as Canadian equities
Fixed income	• Interest income received: 50% • Realized capital gains: 25%
Real estate	• Tax on rental income: 50% • On return of capital: 0% • Currently on deferred capital gains: 0%
Alternative strategies	• Realized capital gains: 50% • Currently on deferred capital gains: 0%
Life insurance	• No tax on gains in cash value in a policy, unless it's cashed in before death

NOTE: Percentages are approximate; tax rates vary by province

WHAT YOU CAN DO NOW

If passive investment income in your corporation is close to, or exceeds, $50,000, you still have time in 2018 to prioritize, plan and make any desired tax-efficient changes. You'll need to minimize or stay below this amount to avoid the reduction for the small business tax rate.

You should reach out to a CMA Network member advisor for a second opinion review that includes:

- A full review of your corporate assets. How is each asset taxed and at what level?
- What's the total of all investment income of your corporation?
- Review all payouts of salary and dividends; does it make sense to make adjustments? Check RRSP and TFSA contributions.
- Is passive investment income under $50,000 and can you keep it there? Can you move it into acceptable structures or other portfolios that can shield some tax?
- Review your insurance needs, including life insurance and critical illness insurance.
- Get a second opinion from the CMA Network member advisor on how you're using your private corporation and cash flow and work with tax specialists who can coordinate with your pro-active accountant.

Some possible solutions and strategies you'll want to consider:

- Corporately owned life insurance to cover risks and create a pension/investment income for you that's been exempted and critical illness insurance
- Salary/dividend payouts enough to maximize RRSP and TFSA contributions
- Individual pension plans, with contributions made by the corporation if it makes sense for you and your family
- Restructure portfolio assets

USING LIFE INSURANCE TO REDUCE PASSIVE INVESTMENT INCOME

Permanent life insurance is likely already a part of your financial plan as a long-term way to protect you and any clinic partners and your family for your estate plans. Corporately owned, permanent, tax-exempt life insurance is an effective way to help reduce passive investment income and keep below the $50,000 threshold. A corporately owned insurance policy that's properly structured is also an effective alternative investment, a way to transfer wealth and a wealth accumulation vehicle – one that does not attract any tax. It's also an effective way to diversity your overall portfolio.

ADVANTAGES OF PERMANENT LIFE INSURANCE

Tax-free Growth

By redirecting some of your corporation's passive investments to pay for a permanent policy (and build up the investment component of the policy), you're able to shelter growth tax free rather than paying income tax on investment growth and being subject to the passive income rules. A permanent type of insurance policy is not considered a passive investment under the new rules.

Performance

Dividends in a participating policy, once paid on the policy's anniversary, are guaranteed by the life insurance company and vested to the policyowner. So are any increases in cash value and death benefit. Canada's large insurance companies manage their participating accounts prudently, and typically as fixed-income accounts for the long-term. Dividend interest rates will vary by company.

Guarantees

Participating life insurance is the only "asset class" with contractually based, guaranteed cash values that increase each year. The cash value and life insurance value, once credited to a policy on each anniversary date, are guaranteed, vested and continue to grow as dividends are paid.

Accessing Cash for Retirement Income

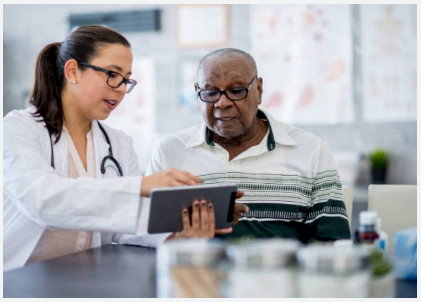
Participating insurance builds up cash value accessible in retirement. There are several methods to access values in a life insurance contract, many being tax free as well. Because everyone's situation is unique, how you access a policy's cash value can be tailored to your individual situation.

It takes a specialized and experienced advisor to properly ensure your plan integrates advice and solutions from the applicable professionals; this includes coordinating your wealth management and risk planning with your tax situation. In our second opinion reviews, we typically find serious gaps in planning that are leaving many Canadian physicians exposed.

SPECIALIZED ADVISORS

Our specialized advisors with the Canadian Medical Advisory Network are well-positioned to examine all your planning needs to tailor strategies and solutions that best suit your practice, your business, your needs and long-term goals. It's important you contact them before the middle of December 2018 to allow time for a second opinion review before the end of the year.

IN FUTURE ISSUES



Individual Pension Plans

In a future issue, we'll look at how professional corporations can use individual pension plans to save for retirement, protect key partners, be tax efficient, and also reduce passive investment income.

Our knowledge. Your gain. Learn more at cmanetwork.com

We live in challenging times. Industry disruption, political evolutions, compliance, tax changes and increasing demand on the health care system are just part of it. Physicians and specialists have unique planning needs and requirements, within the financial world and beyond. You deserve a specialist partner that can integrate multi-disciplinary input from a team of advisors to deliver an integrated and credible long-term plan.

Specialist physicians require specialized financial support. Connect with a CMA Network Advisor today.

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