



## **Innovative Financial Tools for the Affluent and Self-Employed**

Successful and affluent individuals, particularly those that own successful businesses, typically encounter a number of issues with respect to retirement planning and wealth management that often the average working Canadian doesn't. Since very little, perhaps even none, of your retirement income may come from a company pension plan you need to be able to create a comprehensive retirement plan that outlines for you the standard of living you can expect to receive in retirement, possibly without the use of pension assets, integrating your non-registered assets, and perhaps the inclusion of your holding company or other planning tools such as family or testamentary trusts. Consequently, when seeking advice on how to develop such a comprehensive plan it is recommended that you look for a professional financial advisor who specializes in working with self-employed people and is experienced in working with your unique needs.

While your unique needs will vary in number and in scope, this article is intended to address three issues facing successful self-employed, and other affluent, individuals when it comes to wealth management and retirement planning: investing non-registered money in tax-effective ways, the use of holding companies, and the use of testamentary trusts.

### **Tax Sheltering Non-RRSP money**

Given the relatively low maximum RRSP contribution amount and the fact that RRSPs can only be created by individuals and not companies, more and more successful self-employed individuals hold their wealth in non-registered accounts, outside of an RRSP, also referred to as 'open' or 'investment' accounts. While RRSPs are tax-deferred, the growth in a non-registered investment is taxed every year, and the level of taxation differs depending on the type of growth the investment earns. Interest income, which comes from more conservative vehicles such as Guaranteed Investment Certificates (GICs), bonds and T-bills, is taxed at the highest rate –the same as employment income. Dividends and capital gains are both taxed more favourably, relative to interest income, and come primarily from equity-based securities such as stocks.

**Tax-efficient wealth management strategies are available.** Despite the fact that growth in non-registered investments are taxed every year there are investment programs available to affluent investors that makes non-registered investing extremely tax efficient and in most years the amount of taxes due are mitigated significantly, if not deferred completely, and you don't need to change your investment strategy in order to do it.

*Mutual fund corporations*, which are funds built on a corporate class structure, are designed to provide more opportunities for tax-efficiency over typical investment fund trusts. Mutual fund corporations are nearly identical investment vehicles in terms of

underlying investment mandates and access to professional management with liquidity, flexibility, and simplicity. This means you don't need to change your investment strategy in order to access them. They are however, enhanced in terms of taxation with the following benefits:

- The potential to **reduce or possibly eliminate taxable investment distributions** in any given year through pooling of income with expenses and pooling all investment gains with investment losses. This means lower taxes and therefore, the potential higher after-tax growth.

A typical investment trust must deduct the expenses of operating the pool against the income earned in the pool, which is not as efficient in an equity pool as it earns dividends and capital gains. The mutual fund corporation provides the ability to deduct the expenses of operating an equity fund (more tax efficient) against the earnings generated in a cash or fixed-income pool (less tax efficient income) followed by dividends and capital gains earned in the equity pools. This way, if there are any taxable earnings left to distribute, they are dividends or capital gains and never interest.

- Investors may **receive capital gains or dividend income only** –even from the fixed income and cash management classes, which normally attract interest income. This means lower taxes and therefore, potentially higher after-tax growth.

The corporation will use the pooling mechanism mentioned above to eliminate all interest earnings, and/or use a derivative mechanism to replicate the earnings in the fund. The use of this mechanism will generate a nearly identical return to the underlying basket of securities but generates capital gains on the turnover.

- The ability to **defer paying capital gains** generated from switching between pools of the same corporation (taxes are paid when exiting the corporation). This can be of great benefit when rebalancing a portfolio.

The Income Tax Act allows individuals to exchange different classes of shares of the same corporation, with a change to the Adjusted Cost Base, but deferring the triggering of capital gains or losses until disposition of the corporation's shares. The different pools in a mutual fund corporation (such as Canadian Equity or Bonds) are different classes of shares of the same overall corporation.

The traditional advantage to the RRSP is that the contribution is tax deductible and the growth is tax deferred. The potential downside to the RRSP is that you are mandated by the government to begin withdrawing retirement income at age 71 and the withdrawals are taxed entirely as income. With the use of a non-registered mutual fund corporation, while you do not receive a tax deduction for the contribution you can achieve significant tax efficiency on the growth. Withdrawals are made whenever you want, and for an

amount that you want, and they are taxed as capital gains rather than income, which again is more preferred from a taxation standpoint.

### **The Use of Holding Companies**

As a business becomes more and more profitable, retained earnings often accrue within the company after all salaries, bonuses and other expenses are paid. In some cases, individual shareholders choose to hold their operating company shares through one or more holding corporations as there are potential tax and commercial advantages in using this strategy. If a business owner operates more than one company, then he or she may want to consider the use of a holding company in order to improve the cash flow between these two businesses. In the case where there is a single shareholder, dividends can be paid up to the holding company from the operating company and then reinvested in another business without having to pay personal taxes. Alternatively, those funds could simply be held in the holding company away from the liabilities of the operating company. Then, if the operating company ran into financial difficulties, these funds may be protected in the holding company. In some cases, business owners pay all excess cash as dividends up to the holding company and then re-loan these funds back to the operating company and secure them behind any bank loans that may be outstanding. This will protect their interest in the company ahead of the regular trade creditors.

Caution is advised when accumulating excess cash in the holding company since, if more than ten percent of the assets in this company are not used in an active business, the individual shareholder may lose the ability to claim the full \$750,000 capital gain exemption on the disposition of the shares in the holding company. In addition, it is important to note that if the shares of the operating company are subsequently sold by the holding company, the holding company is not eligible for a capital gain exemption and thus may be subject to tax on the disposition.

### **Testamentary Trusts**

Successful individuals spend their working lifetime building their wealth and net worth, and at some point planning needs to take into consideration the eventual transition of the value created effectively on to beneficiaries, whether that be children, grandchildren or other causes such as charitable organizations. While there are a number of innovative strategies designed to maximize the estate passed on to beneficiaries, often little thought is given to what happens to their hard-earned wealth once it is in the hands of the next generation. It is at this stage of the planning process that the use of a testamentary trust may be considered.

Trusts are becoming more and more popular in Canada because they can provide such tremendous flexibility in the financial plan. Trusts can be used to provide assets or income to young or 'less responsible' children or grandchildren, and can be used to ensure that the desired people and causes are taken care of after you are gone while ensuring that nobody is in a position to burn through the wealth you have spent a lifetime building. That level of flexibility aside, what is often most attractive about trusts is the ability to potentially reduce income tax by accessing graduated tax rates, income splitting and beneficiary designations.

Trusts are able to potentially save on tax by accessing graduated tax rates, just like individuals, because they are treated by the Income Tax Act as separate tax payers. As an individual already at the top tax bracket due to your income, if your investment earns \$25,000 in income you will need to pay tax on that \$25,000 at the top rate of 39% (in Alberta) since the \$25,000 of investment earnings is simply added on to your employment income. However, if that investment is held inside a trust and the investment income is the only earnings then it will not be at the top rate, but rather it will be taxed at the same rate as an individual earning just \$25,000 in income. This translates into less tax paid and more earnings left in your investment. Given that each trust is treated as a separate tax payer, if there is the opportunity to use more than one trust then this situation may improve even further.

Taxes can also potentially be saved with trusts through income splitting. When a trust is established for the benefit of an individual and their family (e.g. your daughter, her husband and their children), provisions allow for the income earned in the trust to be paid out to those beneficiaries and taxed in their hands. Any earnings then left over in the trust are taxed in the hands of the trust. If the income earned in the trust is to be used to pay, for example, for the schooling of two grandchildren then the income can be paid to the grandchildren separately and taxed in their hands. Assuming that the income paid is less than the personal exemption amount then no taxes are due (assuming the children earn no other income).

Expertise in investing non-registered money and the use of holding companies and trusts is by no means an exhaustive list of the financial planning and wealth management issues that affluent individuals face, but hopefully it helps to identify that the needs of the self-employed and the affluent may be different from that of the average working Canadian who will likely accept their company pension and turn their RRSPs into a RRIF. Hopefully it also highlights the need to work with a professional financial advisor who specializes in working with business owners and faces these issues regularly. An expert in this arena can help to craft a comprehensive financial plan that integrates your unique needs into a wealth management program that will provide the lifestyle you will be looking for in retirement and ensure that it's tax-efficient and protected from risk.

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