# *Bukovy Financial Services*

# *Presents*


# A Business Owner's Guide To:

# *"Canada Revenue Agency's Best Kept Tax Secrets"*

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## About Us

Bukovy Financial Services is a financial services company that focuses our expertise on aiding business owners to understand and implement little known benefits and tax strategies within the Income Tax Act. We work with our client's trusted and established team of professional advisors in three main areas:

1. Increasing their cash flow
2. Decreasing their Tax Liabilities
3. Increasing their Retirement Benefits and minimizing tax payable

This diversified approach creates a unique cross function focus on both the personal/family and business situations of the business owner to maximize results and benefits.

## The Bottom Line

At Bukovy Financial Services, we clearly understand our clients' needs. We strive to provide the guidance and clarity we would look for as a client, and we are committed to giving service beyond expectations.

Bukovy Financial Services adds excellent value. With over 28 years of providing first-class solutions and great service to business owners in the Thunder Bay area.

**"Business Owner Helping Business Owners"**

# A Business Owner’s Guide to the CRA’s Best Kept Tax Secrets!





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## Introduction

As a small business owner and entrepreneur, you are already aware of the overwhelming amount of effort it takes to make your enterprise profitable. In fact, many small business owners have not taken the time to prepare a personal financial plan that suits their circumstances. Running a successful company and implementing safeguards to ensure its continuity costs money but, to survive in today's competitive economy small business owners must manage these costs carefully.

Making business and personal financial decisions that are tax-effective can help small business owners free up funds to support growth or other business objectives.

Over the twenty-eight years of being a business owner myself, I've found that while the needs of every business owner are unique, there are a number of issues and needs that are common. These issues typically include:

| Small business owners need: | Business | Personal |
|---|---|---|
| **Manage costs effectively** - making cost-effective decisions can help free up funds to support growth or other objectives | ✓ | ✓ |
| **Get great rates on savings and loans** - maximizing every dollar is important for cost-conscious small business owners | ✓ | ✓ |
| **Explore tax-effective strategies** - taxes are one of the top concerns or "pain points" of small business owners | ✓ | ✓ |
| **Protect the business** - ensuring the business is in a position to continue is critically important should the unexpected happen to the owner or a key employee | ✓ | |
| **Protect self and loves ones** - small business owners are people first, sharing the same issues as their customers | | ✓ |
| **Reduce employee turnover** - employee benefits can help business owners retain good people | ✓ | |
| **Protect assets from creditors** - creditor protection strategies to protect their personal assets against creditor claims | | ✓ |
| **Design a succession plan** - it's never too soon to develop strategies for transferring ownership of the business when the time comes | ✓ | ✓ |

# *Secret #1:*
# *Health & Welfare Trusts (HWT)*

A HWT is a Canada Revenue Agency (CRA) approved plan that allows the medical expenses of employees to become a deductible business expense for the employer. An HWT provides affordable coverage for the small business owner. In an effort to control drug costs, two major insurers in the group benefits business (Sunlife & Great West Life) recently announced that they will not be providing coverage for brand name drugs if there is a generic alternative.

As prescription drugs are now the second most expensive item in the healthcare system after hospitals, something has to be done to rein in costs. Most employers are paying the cost of health and dental premiums and costs are rising due to an aging workforce and advances in medical technology. The good news is that whatever prescription drug is used, they will all be covered under the Health and Welfare Trust and usage in this area will probably become more important.

## Highlights

- **Low Cost Non-Taxable Benefit**
  A HWT is a low cost plan with no deductible, no monthly premiums, and no renewal charges. It allows the company to provide employees with a non-taxable medical benefit while ***allowing the company a fully tax deductible expense.***

- **Deductible Business Expense**
  A HWT is an effective way for a business to convert all health, medical, and dental expenses into a fully tax deductible business expense. This can result in very significant savings for both the small business owner and the large corporation.

- **Combine with Other Health Plans**
  A HWT can stand on its own, or can be used as an add-on to an existing plan. Employers determine coverage limits for each class of employee, and can individualize the plan as needs change. Expenses not covered by traditional insurance plans, can become eligible expenses using the HWT.

- **Extensive Coverage**
  The HWT is your medical coverage; therefore it is your choice. Allowable expenses are listed in the Income Tax Act, Section 118.2(2), and include:

  Dental, Prescription Dugs, Optometrist, Optical, Laser Eye Surgery, Chiropractor, Orthodontist, Periodontist, Therapist, Plastic Surgeon, Podiatrist, Dermatologist, X-rays, Crowns, Braces, Massage Therapy, and many more.

## Sample Situation for a Business Owner

An Ontario business owner is at the personal top marginal tax bracket (46.41%) and has family health care expenses of $10,000 for the year.

| Item | Paid Personally | Paid Corporately |
| --- | --- | --- |
| Health Care Expenses | **$10,000** | **$10,000** |
| Pre-Tax Personal Income for Expenses | **$18,660** | **$0** |
| Medical Non-Refundable Tax Credit | **$1,694** | **$0** |
| Corporate Deduction and Expenses | **$0** | **$12,150** |
| Total Cost | **$16,966** | **$12,150 *** |
| **Savings** | **$0** | **$4,816** |

* The $12,150 is comprised of the following:

+ $10,000 of actual health care expenses

+ $1,000 HWT 10% administration fee ($10,000 x 0.10)

+ $50 GST 5% on health care expenses and administration fee ($11,000 x 0.05)

+ $880 PST 8% on health care expenses and administration fee ($11,000 x 0.08)

+ $220 Ontario Insurance Premium Tax 2% of health care expenses and administration fee ($11,000 x 0.02)

**Implementing the HWT allows for a 28.4% savings!**

# *Secret #2:*
# *Insured Retirement Program (IRP)*

## What is an Insured Retirement Program?

Simply put, an **"Insured Retirement Program"** is a plan issued by a life insurance company that allows you to deposit money into an exempt life insurance policy, and shelter all the growth from income tax. Often a business' profits or surplus cash are invested in GICs or taxable investments. These taxable investments may not be the business's best investment option. If the business already needs a life insurance policy for key-person insurance, business loan protection or some other business insurance need, the policy could also be used as a vehicle for investing the company's excess profits.

### What makes the strategy work?
### Why do these plans out perform other non-tax sheltered plans?

First, your earnings accumulate tax free within the plan.

Second, the annual cost of the plan is less than the tax payable on the growth of a similar investment, such as a GIC or bond.

For example, a dollar invested in a taxable investment earning 10%, assuming a 50% tax rate would grow to $2.65 in twenty years. If we used the same dollar and used $0.30 to pay for the insurance while investing the remaining $0.70 into the tax shelter, we would accumulate $4.70 in 20 years.

## Benefits of the Insured Retirement Program

1. **Accumulation fund grows on a tax-sheltered basis**

   Each universal life policy has a minimum and maximum premium. The minimum premium generally covers the cost of insurance, any administrative charges, and anything above the minimum premium up to the maximum goes into the policy accumulation fund. This accumulation fund grows on a tax-sheltered basis. Most insurance companies have a range of investment options that the insured can chose from.

2. **Death benefits are paid out tax-free**

   Applicants can choose between a level death benefit and an increasing death benefit. The increasing death benefit plays out the life insurance plus the accumulation fund. Both amounts are paid out to the beneficiary tax-free.

3. **Premiums withdrawn from the accumulation fund are paid with pre-tax dollars**

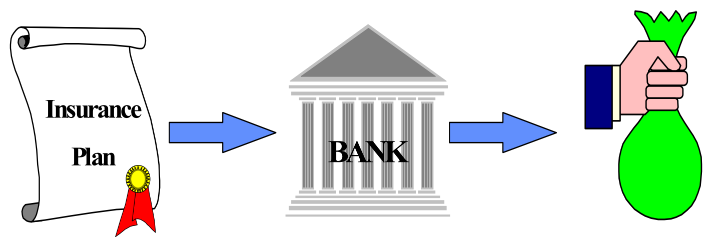
   When the applicant uses the policy accumulation fund to offset the future premiums, he or she is essentially paying their premiums with pre-tax dollars. The money within a universal life policy or the accumulation fund within the universal life coverage grows on a tax-sheltered basis. If the fund never leaves the policy and is used to offset future premiums, there are no tax implications.

4. **Contributions do not impact RSP or tax-free savings account contribution limits**

   Contributions are stand-alone contributions that do not impact other retirement or tax-free savings account contribution limits.

5. **Liquidity and Income**

   If the corporation or shareholder needs access to the cash at some future date, the policy's cash surrender can be withdrawn or used as collateral for a loan. Policy withdrawals may trigger some income tax at the time of withdrawal. Advances to the corporation received as a collateral loan will be tax free.




## Who is it for?

1. Shareholders of private corporations that require life insurance protection (i.e. key person, buy-sell, estate liquidity)

2. Corporations with excess cash flow not required for business operations

3. Shareholders who want to access corporate dollars on a tax-advantaged basis

4. Shareholders who want a low risk investment that requires little management

The IRP is a strategy worth investigating. It's an innovative "insurance tax shelter" that transforms a life insurance policy into a tax free accumulation of funds today, and tax free access to those funds at retirement.

# Secret #3:
# Corporate Owned Insurance

## 1. Business Overheard Expense Insurance

How long would your business survive if you were temporarily disabled? How would you pay the salaries of your employees and meet your monthly expense obligations? According to statistics, approximately 50% of persons aged 35 will suffer a disability lasting at least 90 days before they attain the age of 65.

In the event the owner of a business suffers a disability, their inability to work and generate an income will prevent them from paying the regular monthly bills of maintaining their office. Business Overhead Expense Insurance pays a monthly benefit that is based on the actual monthly overhead expenses of the business and is not based on any anticipated profits.

**When a disability occurs, there are three things that will happen to a business owner:**

1. Their regular living expenses will continue to occur.
2. Their business expenses will continue to incur.
3. The income earned from their business will be severely interrupted.

**Business Overhead Expense Insurance will allow the office to continue to function during a period of temporary or permanent disability by covering the following costs:**

- Rent
- Interest payments for business loans
- Utilities
- Employee salaries
- Equipment rentals and maintenance
- Postage and stationary
- Insurance premiums for employee medical plans
- Professional memberships and subscriptions

These plans can be customized as per the required business needs and will prevent the disruption to the business in the event the owner of the business is unable to pay for the above business overhead expenses.

The premiums for overhead expense insurance are paid and ***tax deductible*** by the corporation as a business expense similar to property and liability coverage. While the benefits from overhead expense insurance are taxable income to the corporation, the benefit payments are used to pay regular business expenses that are generally deductible; such that no net tax liability exists.

## 2. Income Loss Replacement Plan (ILRP)

An Income Loss Replacement Plan (ILRP) is "**an arrangement between an employer and the employees to provide the employees with an income during a disability"**. The employees are insured under individual contracts of disability insurance that are grouped together. An ILRP may be established for as few as two employees.

When an ILRP is established, the premiums paid by the employer are ***<u>tax-deductible</u>***. The premiums are **NOT** included as a Taxable benefit in the income of the employees. However, the monthly benefits received under the disability plan are taxable as employment income.

### Who is it for?

- Employees of any corporation, sole-proprietorship or partnership, who employ a minimum of two employees.
- Employers who need to provide higher levels of disability protection for key employees.
- Employers seeking a cost-effective disability insurance strategy.
- Employees who want income that is guaranteed during disability, for the selected benefit period

### How does it work?

- An employer owns the individual disability contracts.
- Premiums are paid by the employer and **<u>are a deductible business expense</u>.**
- Premiums paid by the employer are **<u>not a taxable benefit to the employees</u>.**
- ILRP disability benefits under the policy will be paid directly to the employee.
- Disability benefits received by the employee while a member of the plan **<u>will be taxable</u>.**

# Secret #4:
# Getting Money Out Tax Free

There are three main ways of extracting money from a private Canadian Corporation tax free.

1. Repayment of shareholder loans
2. Return of paid up capital
3. Capital Dividends

For simplicity, we will focus on #3 – **Capital Dividends.**

When individuals receive salary or bonus from a corporation the amount is fully taxable. But if they choose to receive their income as dividends, approximately only 2/3 of the amount is taxable. When dividends are paid by private corporations to its shareholders, it is important to be aware of the **Capital Dividend Account (CDA).** It is a notional account, is not recorded in the financial statements or accounting records, and is available to all corporations in Canada

## Capital Dividend Account

The Capital Dividend Account allows private corporations to pay tax-free dividends to its shareholders. Generally, a corporation's CDA consists of the following:

- The non-taxable portion of the excess of capital gains over capital losses
- Capital dividends received from another corporation
- The proceeds of an exempt life insurance policy received by the corporation in excess of the Adjusted Cost Basis (ACB) of the policy

**Note**: The proceeds of life insurance plays a major role in the estate and business continuation planning for private business owners. Ordinarily, any capital taken out of the corporation as income is done so as a taxable dividend. The CDA credit, created by the receipt of insurance proceeds, allows the shareholders to withdraw at least a portion of that capital, if not all of it, tax-free. By using life insurance, the business owner may not only have protected the company against potential losses, but to create the ability to pass the value of its assets out of the corporation in the most tax-effective way possible.

# The Benefits of a Capital Dividend Account (CDA)

**Private Corporations**

- 50% of capital gain is untaxed
- Accumulates in CDA
- Amounts in the CDA may be paid out entirely tax-free to shareholders
  - Maximize retirement income
  - Facilitate succession planning
  - Manage taxable income
  - Reduce OAS claw back and other income related factors

By investing in “Corporate Class mutual funds” instead of fully taxable interest bearing investments such as GIC’s, a company can build up reserves for future tax-free distributions to shareholders.

A ***regular dividend*** paid to a Canadian individual taxpayer is taxable and subject to the gross up and dividend tax credit mechanism.

A ***capital dividend*** is tax-free to the shareholders and is a preferred method to distribute cash from a corporation. A capital dividend is paid from the corporation’s Capital Dividend Account. One component of the Capital Dividend Account is the untaxed portion of capital gains

Since the return on Corporate Class mutual funds is mostly made up of capital gains, half of the return from capital gains can be added to the capital dividend account. It is of interest to note that interest earnings inside of corporate class mutual funds qualifies as capital gains taxation and not interest income.

(Please contact your tax advisor for further information on capital dividends.)

# Secret #5:
# The Individual Pension Plan (IPP)

## What is an Individual Pension Plan (IPP)?

An IPP is a corporate defined benefit retirement vehicle funded by your incorporated business.

The object of the IPP is to fund the maximum lifetime pension benefit permitted under the Income Tax Act. Retirement may occur between the ages of 55 and 71.

## IPP vs. RRSP Comparison

| Benefits | RRSP | IPP |
|---|---|---|
| CRA Approved | Yes | Yes |
| Tax Deferred Growth | Yes | Yes |
| Creditor Proof | Partially | Yes |
| Deductibility of Management Fees | No | Yes |
| Taxes Due Upon Death of Spouse | Yes | No (if Children are part of plan) |
| Deposits | Personally (after taxes) | Corporately (before tax) |
| Contribution Room (Current) | 18% of earned income (max. $23,830) | Up to 70% **greater** deposits into IPP |
| Contribution Room (Past) | Unused room carry forward (unlimited) | Back to either 1991 or when the company was incorporated |
| Retirement Benefits | Limited | Guaranteed |

## Target Individual

The IPP is most beneficial for the executive, incorporated professional or business owner who:

- Has attained age 40
- Receives employment (T4) income from the company
- Has service with the company or a related employer prior to plan implementation
- Requires more tax sheltering than is available under an RRSP

## IPP Contribution Example

Illustrated below is the first year IPP advantage for an individual with earnings of $132,334 and service from 1991:

| Age 2012 | 2012 IPP Contribution | 2012 RRSP Contribution | 2012 IPP Advantage |
|---|---|---|---|
| 40 | $93,880 | $22,970 | $70,910 |
| 45 | $145,940 | $22,970 | $122,970 |
| 50 | $203,120 | $22,970 | $180,150 |
| 55 | $265,940 | $22,970 | $242,970 |
| 60 | $334,940 | $22,970 | $311,970 |
| 62 | $364,410 | $22,970 | $341,440 |

Annual IPP contributions, for the subsequent three years are noted below:

| Age 2012 | 2013 Contribution | 2014 Contribution | 2015 Contribution |
|---|---|---|---|
| 40 | $25,840 | $27,780 | $29,860 |
| 45 | $28,380 | $30,510 | $32,800 |
| 50 | $31,180 | $33,520 | $36,030 |
| 55 | $34,250 | $36,820 | $39,580 |
| 60 | $37,620 | $40,440 | $43,470 |
| 62 | $39,060 | $41,990 | $45,140 |

The comparable maximum RRSP contributions are noted below:

| RRSP | 2013 Maximum | 2014 Maximum | 2015 Maximum |
|---|---|---|---|
| | $23,820 | Indexed[1] | Indexed |

The IPP is funded based on retirement at age 65. Where the IPP member elects to retire prior to age 65, a significant contribution may be made to cover the cost of early retirement.

## Is the IPP Right For You?

Contact our office for a no-cost, no-obligation personal estimate of your IPP advantage.

[1] The RRSP limit is indexed annually for inflation using the Industrial Aggregate average wages and salaries in Canada

# Secret #6: Holding Companies

## How To Defer Tax Using a Holding Company

If you happen to own a corporation that carries on an active business, give some thought to setting up your affairs to allow for a deferral of tax. How? By establishing a holding company to own the shares of your active business corporation (ABC). A holding company is a term used to define a corporation which holds assets; it does not typically carry on active business operations. You see, if you own the shares of your ABC directly, then any payment of dividends from that corporation to you will be taxable in your hands personally in the year you receive those dividends. If, on the other hand, you have a personal holding company that owns your shares in your ABC, you can pay a dividend to your holding company that will, in most cases, be tax free to your holding company.

## The Story

John is a business owner who established a holding company (Holdco) several years ago. Holdco, in turn, owns all the shares of John's operating company (Opco), which carries on an active business - he distributes sports equipment.

John pays part of the earnings of Opco to Holdco as a dividend each year. This is generally a tax-free, inter-corporate dividend. John then uses that money to invest in other things, such as real estate, marketable securities, and other private businesses. If Opco needs more cash for any reason, John can arrange for Holdco to lend the money to Opco. John also pays income out of Holdco to himself, and other family members, annually.

## The Benefits

John enjoys a number of benefits from the holding company.

### Tax-free Dividends

Dividends paid by an operating subsidiary (Opco) to the parent holding company (Holdco) in Canada are generally tax-free dividends to Holdco. Tax free is always good.

## Creditor Protection

Because John has excess earnings in Opco each year, he pays the excess to Holdco as a tax-free dividend, which protects those earnings from creditors of Opco. If necessary, he can lend that money back to Opco on a secured basis to retain that protection from creditors.

## Efficient Reinvestment

John has been reinvesting some of Opco's excess earnings in other assets to diversify his holdings. He does this by paying tax-free dividends from Opco to Holdco and then having Holdco make those other investments. If he paid the excess earnings from Opco to himself, personally, to make those investments, he would pay tax first, leaving less to reinvest.

## Income Splitting

John is able to pay income (salary or dividend) to his wife and children each year so that some of the earnings are taxed in their hands, not his. Because John's children have very little other income, they'll pay no tax at all on the income he pays to them. You do have to be aware that dividends paid to minors (perhaps through a trust) will be taxed at the highest marginal tax rate. But once the kids reach age 18, they can receive up to about $40,000 (it varies by province) each year in Canadian dividends virtually tax free.

## Timing Income

Think of Holdco as a private pension in many ways. John can draw money out of Holdco when he wants it. He chooses to pay himself dividends every second year rather than every year, which allows him to avoid personal tax installments, because it's possible to base installments on either the previous year's tax owing, or the current year's expected liability. If John has little or no tax liability every second year, he can base his installments annually on the year he expects to have little income.

Individuals interested in creating a holding company should first seek assistance from a lawyer, accountant and/or other qualified professional, to determine the pro’s and con’s.

## A Word Concerning Personal Guarantees

It is quite common for small businesses operating as private limited liability companies to have shares held by two or three shareholder employees.

This usually happens when a company is growing – it needs more space, equipment, or financing for its accounts receivable or inventory.  The shareholders approach a lending institution to borrow the money the company needs.

The lender approves of the company's plans and approves the loan requiring the personal guarantees of the shareholders as additional security.  Once the guarantees are in place, the lender has access to the personal estates of the shareholders, over and above the company's assets.

During the term of the loan, one of the shareholders dies.  His/her shares are sold to the surviving shareholders under the terms of a buy/sell arrangement.  The deceased's executor, having exchanged shares for cash has no further interest in the company's affairs, but what about the personal guarantee given by the deceased to the lending institution?  It still exists and is binding on the estate.

The executor would, of course, approach the lender to request cancellation of the personal guarantee given by the deceased.  The lender might agree.

On the other hand, the lender might decline the request and would almost certainly do so if the shareholders death were likely to cause difficulty, or if the death occurred during a general economic downturn that was likely to affect the company's sales or profitability.  Why would a lending institution release the guarantee?  The estate of the deceased employee is the most liquid security the financial institution has.

Most small to medium sized private companies are indebted to lending institutions in one way or another.  The giving of personal guarantees is a widespread practice.  Funding buy/sell agreements with life insurance is also a common practice due to its cost effectiveness.

Unfortunately, the provision of additional life insurance to retire any company indebtedness and thus eliminate a deceased shareholders personal guarantee is often overlooked, especially when the provision of insurance is not a condition of the loan.

Life insurance can be used to protect the interests of a small business owner and to ensure the continued operation of the business itself.  It can provide security for creditors during a period of change and assurance that the business will continue even if a key person departs.  It can also be instrumental in attracting and retaining excellent employees, who will work to assure the continued success of the company.

## Final Comment:

As previously stated, this is not a complete book on income tax or on income tax reducing strategies for business owners, but the techniques offered herein are proven, well used, and successful.

Over the 28 years of being a business owner myself, I've found that while the needs of every business owner are unique, there are a number of issues that are common on which I can provide advice:

- **Building personal wealth** - how to convert some of your business's excess income into personal investments

- **Minimizing taxes** - how to withdraw retained earnings out of your business without incurring a large tax bill

- **Estate Planning** - issues you'll need to consider to ensure the smooth, tax-efficient and organized transfer of your assets to heirs.

- **Retirement Planning** - helping you enjoy a financially secure retirement by combining succession planning with tax-advantaged retirement planning

If you would like to learn more about the strategies mentioned in this free report, please contact my office to arrange a complimentary consultation. If you are currently too busy to meet during regular hours, my schedule is flexible and we can arrange a time to meet at your convenience.

**Please visit our website at: [http://www.panicorpeaceofmind.com](http://www.panicorpeaceofmind.com) for more information about our services and friendly staff.**

**I wish you the best in your current tax planning strategies.**

**Ray Bukovy CFP CPCA**

# Our Personalized Range of Services

## Business Risk Planning

Today's business owners are faced with a complexity of issues and are generally too busy building their enterprise to take the time to deal with the risks that can devastate their efforts. Many issues, such as Buy-Sell Agreements, Holding Companies, Corporate Owned Life Insurance, Estate Freezes as well as many Tax and Estate issues are best dealt with by a professional who shares your business concerns and has the experience to eliminate the risks.

## Tax Planning & Preparation

"Ouch!" Taxes are a very touchy subject with most business owners especially since the tax system is highly complex and can be very frustrating. This is an area that is best left up to the experts. Therefore, we use tax experts to assist us in making effective recommendations for our clients.

## Insurance Planning & Risk Management

Insurance Planning ties into financial planning by uncovering and verifying your insurance needs without leaving you to unknown vulnerabilities or unnecessary coverage. The world of insurance planning has evolved to encompass a wide range of solutions including Life, Disability, Critical Illness and Long Term Care Insurance.

## Strategic Alliances

We recognize the unique nature of a business owner's financial situation. Therefore, we use strategic alliances with specialists in related areas to ensure the most appropriate solutions are found. In addition, we have strong relationships with major financial institutions, accountants and lawyers to aid us in our search for the best possible solutions for our clients.

## Retirement Income Planning & Investment Planning

Your Retirement: Panic or Peace of mind? Do you have a retirement plan? Are your investments structured to best manage market downturns? Our RIP (Retire in Peace) Planning Process enables you to answer these questions. Retirement Planning enables us to clarify what will be most important during your retirement and formulating a plan that best suits your needs. With your goals and objectives as the foundation of the plan, regular monitoring and in-depth annual reviews you can rest assured your future retirement will encompass everything that is important to you... while providing peace of mind today.

## Estate Planning

Wills, Power of Attorney, Probate, Estate Taxes, Charitable Donations, Creditor Protection and Business Succession Planning are but a few factors involved in the area of estate planning. As complicated as it may be, estate planning is an intricate part of the financial planning process and can alleviate stress and confusion during difficult times.