

COMPASS

A newsletter designed to help affluent families navigate their financial possibilities

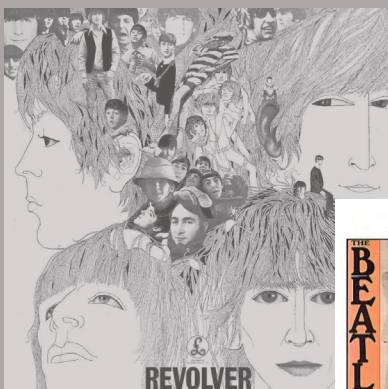
The Taxman

By John Nicola CFP, CLU, ChFC

*Let me tell you how it will be
There's one for you, nineteen for me
'Cause I'm the taxman
Yeah, I'm the taxman*

*If you drive a car, I'll tax the street,
If you try to sit, I'll tax your seat.
If you get too cold, I'll tax the heat,
If you take a walk, I'll tax your feet.*

- THE BEATLES



A few years after the Beatles gained international stardom, they ran into a few financial challenges with the Crown; specifically, taxes. In 1966 George Harrison wrote the song, *The Taxman* with a famous line suggesting that the tax rate was 95% of income “there’s one for you and nineteen for me.”

To be fair, that was an exaggeration in 1966. The maximum tax rate in the UK at that time was 90% on investment income. However, it should be noted that by 1974 maximum tax rates rose in Britain to 83% on work income and 98% on investment income.

Interestingly, these massive tax rates did not appear to:

- Lower the deficit
- Redistribute wealth
- Improve the economy
- Lower inflation
- Reduce unemployment

They did, however, cause the Conservatives to elect Margaret Thatcher as their leader in 1975. She of course became Prime minister in 1979 and completely changed the direction of British Economics.

So, what do the tax tribulations of England’s swinging sixties have to do with our current tax environment? I believe, quite a bit. Here are the primary issues: *Sentiment around unfair taxation*. There is a strong narrative in many countries that the wealthy are not paying their proper share of taxes and that income and wealth inequality are rising.

Will the Liberals play ball with the NDP? In the last election, the NDP campaigned on a program that would raise income tax rates for those who earned more than \$220,000 per year, plus increase the capital gains inclusion rate by 50-75% instead of 50%. Furthermore, they would like to introduce a wealth tax of 1% on all assets over \$10M of value owned by individuals. Will the Liberals make budget compromises with the NDP in order to garner their political support?

How to fill the hole of debt. We have passed \$1 trillion of Federal debt and when provincial debt is added, government debt is now at approximately 117% of GDP on a gross basis and 92% on a net basis. That is an increase of more than 25% in a single year. While still typically lower than other countries, we have not seen this level of debt to GDP since the early '90s. With interest rates still near record lows, servicing this debt has not been an issue, but when rates do rise both federal and provincial governments will likely be looking for revenue. With these issues top of mind, I'd like to focus on answering three key questions:

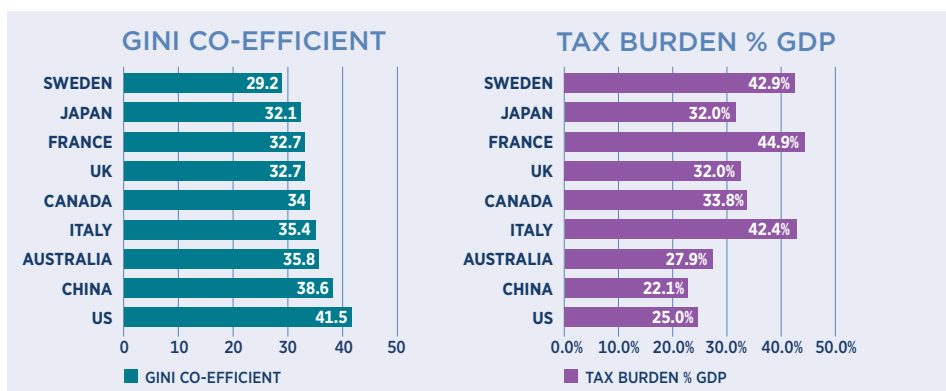
- How much inequality is there in terms of income and wealth overall and specifically in Canada? What are some of the key factors that cause this inequality? How does Canada stack up to the rest of the world?
- If taxes are going to rise, then where and how might that happen?

What steps can individuals and families take to improve their overall tax structure? Let's take a look at a number of options including effective with portfolio design, leverage, the use of private companies and trusts, insurance etc.

The Gini Coefficient is a statistical measure meant to show the level of income or wealth inequality in a country or society. Created by the statistician/sociologist Corrado Gini it has a range from 10 (everyone has the same income or wealth) to 100 (only one person has all of the income or wealth). That means that the higher a country's Gini Coefficient, the less equal it is with respect to the distribution of income or wealth.

Another measure that is relevant to the distribution of wealth is the tax burden within any given country when compared to the overall economy as measured by GDP. The greater the tax burden, the more government has in resources to redistribute income and wealth.

The two graphs below show both the Gini Coefficient and the tax burden for a select number of the Organization for Economic Co-operation and Development (OECD) countries. In theory, higher tax burdens should lower Gini Coefficient levels, but as you can see below, they often do not accomplish that.



Observations

- France, Japan, and the UK have almost identical levels of income/wealth equality, but France takes approximately 40% more in taxes to accomplish that result.
- Italy collects far more taxes as a % of GDP than Canada but has a less equal society financially.
- In countries such as the US and China, there seems to be a correlation between lower taxes and higher inequality of wealth and income.
- Sweden does have the best number in this group at about 10% better than Japan; however, by one measure the cost to achieve that improvement are taxes that are approximately 30% higher as a % of GDP. Is this a reasonable trade-off?

Demographics and Dough

“When I was young I thought that money was the most important thing in life; now that I am old I know that it is.”

– OSCAR WILDE

One of our primary roles as advisors is to help our clients accumulate sufficient wealth to be able to retire comfortably and be financially independent. That means their wealth as a percentage of their income must rise significantly over their working lifetimes or they will never realize their goals.

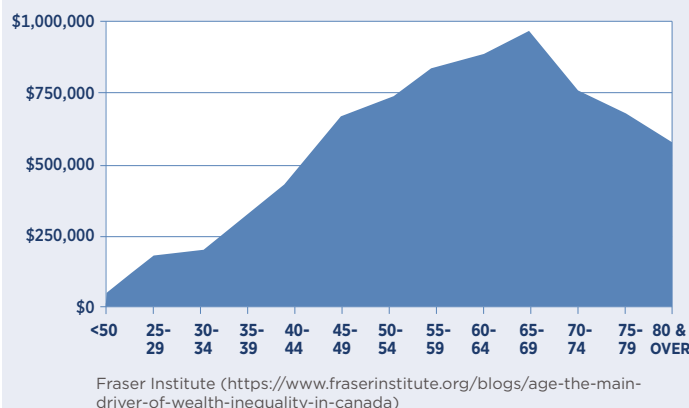
Will Sutton (1930s bank robber) was asked why he robbed banks. His reply was “because that’s where the money is.” Today, the money appears to be with older people and that explains a large part of what we see as a concentration of wealth. Consider the two images below; the first from the Fraser Institute shows how steep that wealth curve is until just after 65. It drops as one would expect considering spending of retirement savings, gifts to children and charities.

Even when we talk about “the top 1%,” of net worth’s in Canada, the trends are identical. Household wealth amongst the wealthiest Canadians peaks at around age 65*. Typically, any country whose population is aging will see similar results and that means wealth and income become more concentrated. We could of course prevent this accumulation of wealth by telling individuals not to save and cancel, RRSP’s, TFSA’s, and pensions. We could make it illegal to own a home. I am sure I could provide more ridiculous ideas than these but suffice to say that having a wealthier older population takes a great deal of financial strain off the rest of the population.

If taxes rise on the basis of income or wealth, they will fall disproportionately more on older Canadians.

*<https://www.thekickassentrepreneur.com/net-worth-by-age-percentile-calculator-for-canada/>

AVERAGE HOUSEHOLD WEALTH IN CANADA BY AGE GROUP



TOP 1% NET WORTHS IN CANADA

THE NET WORTH YOU NEED AT EACH AGE TO BE IN THE TOP 1%

AGE	HOUSEHOLD	INDIVIDUAL
25	\$ 405,737.00	\$ 202,868.50
30	\$ 811,472.00	\$ 405,736.00
35	\$ 1,622,945.00	\$ 811,472.50
40	\$ 2,434,417.00	\$ 1,217,208.50
45	\$ 3,651,626.00	\$ 1,825,813.00
50	\$ 4,868,834.00	\$ 2,434,417.00
55	\$ 6,491,778.00	\$ 3,245,889.00
60	\$ 8,114,724.00	\$ 4,057,362.00
65	\$ 9,737,667.00	\$ 4,868,833.50
70	\$ 8,114,724.00	\$ 4,057,362.00
75	\$ 6,491,778.00	\$ 3,245,889.00
80	\$ 5,680,307.00	\$ 2,840,153.50

Source: The Kickass Entrepreneur.

What's to come

Let's move our attention to what kinds of taxes we could expect to see introduced. In the US, the Biden administration is determined to see significant increases in corporate taxes, income taxes on high income earners, changes to capital gains taxes and estate taxes. This is meant to fund almost \$4 trillion of stimulus spending. You will remember, during the Trump administration taxes were dropped for both businesses and high-income taxpayers. It is difficult to know how much of these tax increases will make it through congress but, as they are now, the maximum federal tax rate could reach almost 44% on individuals. When combined with state income taxes it would mean a blended rate in excess of 50% in states like New York and California. Corporate tax rates would rise to the same level as Canadian corporate tax rates. However, in Canada, we have a small business tax rate which is only about

12% for business profits under \$500,000 per year. There is no equivalent to this in the US.

Here are the potential scenarios most vulnerable to higher taxes in Canada:

- **Excess profits tax of 3% on Canadian Banks and Life insurers** with respect to profits over \$1 billion per year. With RBC earning well in excess of \$10 billion per year this new tax would cost them about \$300 million per year.
- **Capital gains inclusion rate rising to 75% from 50%.** This would increase the maximum effective tax rate on capital gains to about 40% in BC and Ontario. This one appears to be more difficult for the government to implement and exceptions would likely be made for smaller gains and stock options (as is the case now with shares of private businesses and farms). This is an area where proactive planning and portfolio design can make a difference.
- **Higher taxes on ordinary income.** In the US, the new Biden proposals are expected to increase the maximum federal rate to 39.6% at \$400,000 of income (\$500,000 CDN). When combined with average state income taxes in the 5% range the overall marginal rate would be around 45%. In BC and Ontario, we are at almost 54% at any taxable income above \$220,000 CAD. Nevertheless, if income tax rates are to rise then it is this group who will feel the brunt of any changes.
- **CRA enforcement and interpretation of advanced tax planning.** Recently the CRA has been more assertive in its re-assessment of tax planning strategies it disapproves of. These include the use of what is known as non-CCPC corporate structures (foreign private companies) and corporate reorganizations that can allow dividends to be converted to capital gains. It remains to be seen if these re-assessments will be challenged in court and if so, what the outcomes will be.

One could be forgiven for thinking that things look bleak for high-net-worth and high-income families and individuals. However, there are still many effective, and in some cases, safe and simple planning that can be done to mitigate tax. The slide below summarizes a few of them.

Planning Options

SALARY VERSUS DIVIDENDS

trust

Prescribed Rate Loans

Life Insurance as an Asset Class

Insurance With or Without Leverage

IPP vs. RRSP Over Age 50

Tax Efficient Asset Allocation

Many of the best options with respect to effective tax planning have been available for several years.

Salary vs. Dividends

Previously, it was better for most business owner-operators, or those who owned a professional practice, to take the majority of their compensation in salary. Today that pendulum has swung back (in most cases). For the majority of self-employed individuals who are also incorporated, a salary combined with maximizing RRSP or IPP contribution will be more tax efficient. We compared the total amount of tax an individual would pay corporately and personally on \$200,000 of pre-tax income in two different forms:

- Salary with Maximum RRSP contribution (\$27,830)
- In-eligible dividends
- Eligible Dividends

Total tax liabilities (rounded)

- Salary- \$44,320
- In-eligible dividends - \$67,200
- Eligible dividends -\$67,600

*All of the above numbers assume a BC resident

Individual Pension Plans

IPP's were first introduced as an option for incorporated professionals and business owners in 1991. Space does not permit a detailed analysis here but for individuals over the age of 45, IPPs tend to offer considerably higher levels of tax-sheltered retirement savings than RRSPs do.

Key factors include:

- How long the individual has been employed by their corporation
- How old they are
- Whether they choose to fund the maximum past service and also fund special terminal amounts just prior to retiring

IPPs are quite capable of accumulating more than double the retirement capital of RRSPs over the same period of time.

Prescribed rate loans

Usually, if an individual gifts capital to either a spouse or children to invest, the income earned on that capital is attributable back to the individual. One exception is where the capital is lent not given and a prescribed rate of interest is paid on that loan. Right now, because of very low interest rates the prescribed rate is 1% and can be locked in for long periods of time. Assuming the return on the capital lent is more than 1% annually then the additional return would be taxed in the hands of the person or trust receiving the loan. In the right circumstances this can be a very effective way of income splitting between family members.

Life Insurance

Certain permanent life insurance policies (whole life and universal life) build cash values that grow over time with no income tax on that growth until the policy is redeemed. If the policy is never redeemed and remains in force until death, then no tax is paid at all.

The cash values of whole life policies, in particular, have the advantage of high safety and liquidity and as such have similar risk characteristics to safe bonds. Over a longer period though, returns are likely to be higher and as noted there is no tax as the cash value grows.

Because the risk inherent in whole life cash values is so low, most banks will provide loans or lines of credit using life insurance as collateral at a level of 90% of the cash value.

Given this one very effective investment strategy is to fund a whole life policy, borrow against the cash value and invest in other assets that might have higher return prospects over time (such as real estate or public and private equity). The cash value grows tax deferred and the interest expense reduces the taxable returns of the other assets.

Portfolio Design

Portfolio design is not just about getting your optimal asset allocation; although, that is a critical component of achieving the best risk-adjusted returns before taxes. If we ensure that we put the right assets into the right structures, we can have a very significant impact on how much tax is paid on overall returns. We have used this model with our own clients over the last five years and have, in many cases, been able to reduce the taxable amount of their portfolio to 30% of their annual return.

Even assuming the marginal rate on taxable investment income is 50%, the effective tax rate is about 15%.

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