The Navigator

RBC WEALTH MANAGEMENT SERVICES

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Ontario's top combined tax rate to increase to 49.53%

Planning strategies for Ontario residents approaching or earning income greater than $500,000

On April 24, 2012 the Liberal Government of Ontario passed a confidence vote by agreeing to impose a 2% increase to the top Ontario marginal tax rate on income earned by individuals over $500,000. Subject to the approval of the Legislature, the 2% increase combined with Ontario's surtax will increase the top Ontario marginal tax rate from 17.41% to 20.53%. This measure will result in a combined Ontario and federal top marginal tax rate of 49.53% effective on July 1, 2012, an increase of 3.12% over the current top rate of 46.41%.

The Government estimates that this measure will result in additional revenue of approximately $280 million in 2012-13, $470 million in 2013-14, and $495 million in 2014-15 and will affect approximately 23,000 Ontario taxpayers. This new tax bracket is proposed to be eliminated when the provincial budget is balanced in the 2017-18 tax year.

You should obtain professional advice from a qualified legal or tax advisor before acting on any of the information in this article. This will ensure that your own circumstances have been considered properly and that action is taken on the latest information available.

Wealth taxes imposed by other countries

There's a trend towards imposing a greater share of financial responsibility on wealthy individuals as a means of addressing economic challenges. Similar to Ontario's new tax bracket, some countries, such as the United Kingdom, attempted to accomplish this by increasing the tax on income earned above a certain threshold. Other countries such as France, Norway, Switzerland and India have imposed a 'wealth tax' on the worldwide assets of their residents above certain thresholds, rather than on their annual incomes.

A comparison can be drawn between the Ontario proposals and the experience of countries that have imposed a 'wealth tax'. For example, France imposes a 'wealth tax' on individuals resident in France whose net worldwide assets exceed certain thresholds. In the French scenario, for 2012, individuals with net assets worth between EUR €1.3 million and EUR €3 million are subject to a tax of 0.25%. Those with net worldwide assets exceeding EUR €3 million are subject to tax at 0.50% on the value of those assets. A candidate in the upcoming election has called for a 75% tax on those earning annual incomes in excess of EUR €1 million. This could potentially represent both a tax on assets and on income for the wealthy.

In the United States, which currently does not have a wealth tax, President Obama has proposed that a minimum tax of 30% be imposed on individuals with annual incomes exceeding USD$1 million. A recent poll suggests that a majority of US voters support the initiative but the proposal has been rejected by the US Senate and opponents claim that such a measure would discourage investment and would not have a positive impact on deficit reduction or unemployment.

It is also worth noting the experience of the UK, where a 50% top marginal tax bracket was put in effect in 2010 for individuals earning in excess of GBP £150,000. The March 2012 UK budget proposed to reduce this top marginal tax rate to 45%. Analysis of the effectiveness of the higher marginal tax bracket as a temporary measure to boost tax revenues, suggests that it failed to meet expectations. This may have been due to the effectiveness of tax planning strategies employed by affected individuals.

Tax minimization strategies for individuals

In light of Ontario's new proposed tax bracket, there are several tax planning strategies you may wish to explore. The following is a non-exhaustive list of tax minimization strategies to consider with your professional advisor.

Put family income-splitting structures in place

Family income splitting is the bread and butter of tax planning in Canada, but many Canadians are not taking advantage of simple income-splitting opportunities that have already been acknowledged by the Canada Revenue Agency (CRA) as acceptable strategies. If you have a low-income spouse or low-income children or grandchildren, now is a great time to consider setting up a prescribed rate loan for income splitting.

To ensure that income-splitting strategies are implemented appropriately to help you reduce your taxable income, it is important to understand the impact of the 'attribution' rules in the Income Tax Act. These rules have the effect of attributing taxable income back to the tax return of the family member who supplied the capital for investment, with the effect that no tax savings are achieved.

The attribution rules may be avoided by making a prescribed rate loan to a properly structured family trust or to a spouse using a formal loan agreement. The family trust or your spouse pays you annual interest on the loan that you must include in your income, however, when properly implemented the tax savings more than compensate for this. What's more, the CRA prescribed interest rate at the time of writing continues to be at a historic low of 1%, so now is the time to maximize the benefits of this tax planning strategy. Once the loan is established, the prescribed rate is maintained for the life of the loan regardless of any increases that may occur to the prescribed rate.

Family Trust

If you have children, grandchildren, nieces or nephews with little or no income then you may consider establishing a family trust to shift investment income and capital gains that would otherwise be taxed in your hands at a high marginal tax rate, to the hands of your low-income family members. Each person in Ontario, regardless of age, is able to earn about $9,400 of interest income, $18,800 of capital gains, or $47,800 of Canadian public company dividends tax free every year if they have no other income in the year. The tax-free income earned in the family trust can also be used to pay for your child's expenses (private school fees, lessons, gifts, etc.), which you may have been paying all these years with after-tax dollars. Parents and trustees should speak to their legal or tax advisor for further advice and guidance on this matter before using trust income to pay for the children's expenses.

If structured properly, a family trust is a trust structure that can allow a parent or grandparent to split income with their lower-income family members. Speak to your RBC advisor about the RBC Family Trust solution to take advantage of this annual income splitting opportunity.

Spousal Loan

If you have a low-income spouse, consider establishing a spousal loan to shift investment income and capital gains that would otherwise be taxed in your hands at a high marginal tax rate to the hands of your low-income spouse. The strategy involves you transferring funds to your low-income spouse through a special formal loan arrangement at the CRA prescribed interest rate. Your spouse is then able to earn investment income on these funds and pay taxes at their lower marginal tax rate.

A spousal loan is created when investment capital is loaned by a high-income family member (the lender) to a low-income spouse or family trust (the borrower) using a formal written loan agreement. The interest rate on the loan must be at least equal to the CRA prescribed interest rate in effect at the time the loan is established.

Establish TFSAs for adult family members

To reduce your taxable investment income, consider making a gift to your adult family members to enable them to contribute to a Tax-Free Savings Account (TFSA). Since all the investment income in the TFSA grows tax-free, there will be no income attribution, regardless of who funds the account.

Invest tax efficiently with corporate class funds

Consider investing in corporate class mutual funds whose objective is to minimize distributions to the unit holders. By combining the income and expenses for all of the different funds under its corporate umbrella, expenses from one fund can be used to shield taxable income in another fund. This may result in lower taxable distributions and may reduce the amount of taxable investment income on your non-registered investments. When you eventually redeem the units you'll pay tax on any capital gain realized.

Corporate class funds offer the flexibility of making portfolio adjustments if and when required without having to consider the immediate tax implications of doing so. Switching between funds within the same corporate class structure can be done without triggering a taxable event. This means you can rebalance your account or make changes to your asset mix without worrying about the income inclusion.

If you invest in bonds or bond funds, you may know that the interest income you earn is taxed at your highest marginal tax rate. Corporate class funds may offer bond funds that generate tax-efficient capital gains, which are taxed at half the rate of interest income.

The corporate class structure is an ideal investment solution for individuals who have maxed out their RRSP and TFSA and may be looking to:

1. Build their non-registered investment account with a tax-efficient solution – *tax deferral benefits without the contribution limits.*

2. Earn higher after-tax yields – *through capital class funds*

that generate bond fund returns with capital gains tax treatment.

3. Rebalance their account while avoiding certain tax consequences – *choose the time that works best for you to pay tax.*

4. Maximize their charitable donations – *maximize their contribution by using these tax deferral opportunities.*

Establish a corporation to earn investment income

It may be better to earn investment income inside of a corporation especially if you don't need all your investment income for your lifestyle expenses. In general, investment income includes interest, taxable capital gains, rental income, royalties and foreign income. In Ontario, investment income earned by a corporation is taxed at a high rate of 45.92%. A portion of that tax is refunded to the corporation when it pays a taxable dividend to its shareholders. If this income is earned personally after the proposed new Ontario tax bracket is implemented, it will be subject to tax at a rate of 49.53% assuming you are in that top tax bracket. As you can see, there is some deferral of tax by earning investment income in a corporation. The benefit of this deferral is better the longer the funds can stay inside the corporation.

If the proposed new Ontario tax bracket is implemented, an individual at the top tax bracket will pay combined corporate and personal tax of 48.70% on interest income earned in a corporation and then paid out to them as a dividend. That same income earned personally would be taxed at 49.53% – a very slight advantage.

If you don't already hold your investments in a corporation, you may transfer them to a corporation on a tax-deferred basis. As always you should consider the costs of using a corporation since the administrative cost will be slightly higher.

Invest in flow-through shares to reduce taxable income

Some high-income earners invariably entertain the thought of purchasing a flow-through investment before year-end to create tax deductions to significantly reduce their taxes payable. If you are considering purchasing these investments, you should realize that not all are created equal, and consequently, as a result an impulsive purchase might be costly. It is very important to consider the quality of the investment, and not just the potential write-off. As the saying goes "A good tax shelter that is a bad investment is really a bad tax shelter".

A flow-through is a type of tax-advantaged investment designed to encourage investing in resource companies that are engaging in exploration and development in the mining, oil and gas, and renewable energy and energy conservation sectors. If structured properly, Canadian tax laws allow certain expenses incurred by the resource company to be "renounced" or "flowed through" to you and can be deducted by you personally on your tax return up to the maximum you paid for the investment. You may apply the deductions against all sources of income, thereby reducing your net income. This is what may result in tax savings for you.

Donate to charity

Due to the calculation of the donation tax credit, donations above $200 can result in a tax savings equal to the top marginal tax rate.

As an alternative to cash, you can also donate publicly listed securities in-kind to qualified charities without being subject to tax on the capital gain. You will receive a donation tax receipt equal to the fair market value of the security at the time of the donation. This can help reduce your income tax payable on your other income.

If you have thought about leaving a legacy but are unsure about the best way to accomplish this, then speak to your advisor on the benefits of donating cash or securities in-kind to your own charitable foundation such as the RBC Charitable Gift Program.

Tax-exempt life insurance

Do you have surplus assets that you know will be passed on to your heirs when your estate is settled? If so, it probably does not make sense to continue exposing the income from these assets to your high marginal tax rate, even more so now with the proposed new tax bracket. If there's an insurance need, consider speaking to your insurance advisor about putting these highly taxed (typically interest-bearing) assets into a tax-exempt permanent life insurance policy. Permanent life insurance policies (whole life and universal life) provide both an insurance protection and a savings component. The income earned on the savings component of a permanent life insurance policy that is an "exempt policy", as defined in the *Income Tax Act*, grows on a tax-sheltered basis. This way, the amount of tax that would normally be paid to the CRA on the income earned on these surplus assets could instead be paid to your beneficiaries in the form of a tax-free death benefit. Speak with your RBC advisor if you would like a referral for insurance.

Make RRSP contributions

By investing in a registered retirement savings plan (RRSP), you can deduct the amount of your RRSP contribution from your taxable income, up to your annual RRSP deduction limit, thereby reducing the taxes you will have to pay. In addition, funds in an RRSP can grow on a tax-deferred basis. The investment income and capital gains generated in the plan are not subject to tax until you withdraw them from the RRSP, or from a registered retirement income fund (RRIF) if you have converted your RRSP to a RRIF.

Increase non-taxable employee benefits and decrease salary and taxable benefits

If you are an executive and are in a position to negotiate how your compensation package is structured, you may want to negotiate an increase in non-taxable benefits in exchange for salary, bonuses or other taxable benefits. Non-taxable benefits include private health services plans, registered pension plans such as an Individual Pension Plan, group sickness or accident insurance plans and disability insurance, training or education expenses, home computers and internet, scholarships and childcare as long as certain conditions are met.

Incorporate a Personal Services Business

Consider incorporating yourself as a corporate employee and earning your employment income through a corporation. Your corporation will be considered a personal services business (PSB) and although you are earning active business income, your income will not be eligible for the small business rate. Draft legislation released by the federal government on October 31, 2011 proposes to increase the rate of tax charged on income earned by a PSB in Ontario to 39.25%, significantly less than the 49.53% new proposed rate on income earned by an individual above $500,000. Any amount earned in the PSB that is not needed for your personal expenses can be retained in the corporation and taxed at 39.25% instead of 49.53% in your hands personally. Note that this proposed legislation has not passed into law. A taxpayer remains potentially liable for taxes under current law in the event that a proposal is not ultimately passed.

A PSB is only allowed to deduct remuneration and benefits for the incorporated employee. If your are a salesperson receiving commissions, the corporation is only allowed to deduct expenses paid by the corporation that would have been allowed as a deduction to you personally as a commissioned salesperson had you incurred the expense yourself. The PSB would also be allowed to deduct legal expenses incurred in collecting amounts owed to it for services rendered.

Of course your employer would

have to be willing to do this. In addition, you should consider the costs involved with incorporating as well as the ongoing administrative costs.

Establish a Retirement Compensation Arrangement

If you are an executive and are in a position to negotiate how your compensation package is structured, consider the pros and cons of having your employer establish a Retirement Compensation Arrangement (RCA) as a component of your compensation. A RCA is a type of employer-sponsored, funded retirement savings arrangement which permits larger contributions compared to allowable registered plan contributions. Contributions to a RCA are not included in your taxable income, which may reduce your income subject to the new Ontario tax bracket. Employers are able to deduct 100% of the contribution at current tax rates. At retirement, distributions to you from the RCA will be fully taxable as other income. The RCA therefore allows you to defer tax on the amounts contributed to the RCA by your employer.

In addition, a RCA may save you tax if you expect to be in a lower tax bracket or a non-resident of Canada when you receive distributions.

Tax residency planning

Some individuals may go so far as to consider moving to a lower tax province. Provincial tax residency is based on where you lived on December 31 of the taxation year. For example, if you establish residential ties in the province of British Columbia on December 31, 2012, then your income for 2012 (other than business income earned in another province) will be based on British Columbia rates rather than Ontario rates. Residency status is always a question of fact and is based on residential ties in each province. Residential ties are examined to determine whether or not an individual leaving Ontario remains resident in Ontario for tax purposes.

The table below sets out the 2012 top combined provincial and federal marginal tax rates for the Canadian provinces and territories:

Province	Top combined provincial and federal marginal tax rate
Ontario[1]	49.53%
British Columbia	43.70%
Alberta	39.00%
Saskatchewan	44.00%
Manitoba	46.40%
Quebec	48.22%
New Brunswick	43.30%
Nova Scotia	50.00%
Prince Edward Island	47.37%
Newfoundland & Labrador	42.30%
North West Territories	43.05%
Yukon	42.40%
Nunavut	40.50%

[1] Ontario's top marginal tax rate for income earned on or before June 30, 2012 is 17.41% (11.16% x1.56% surtax). Effective July 1, 2012, Ontario's top marginal tax rate will increase by 3.12% to 20.53% (13.16% x 1.56% surtax).

Tax minimization strategies for business owners

Withdrawing cash from your corporation

If you need the corporation's surplus funds for personal use, there are different ways to withdraw those funds, each with different tax implications. Consider using the following strategies first to get funds out of a corporation tax-free or tax-deferred before paying a taxable salary or dividend:

- Reimburse yourself for business expenses you paid personally;
- Repay amounts owed to you by the corporation;
- Pay a capital dividend;
- Reduce the amount of paid up capital on your shares.

Keep more money in your corporation

As a small business owner, you may have your corporation pay you a taxable dividend with after-tax dollars of your corporation. With the proposed new tax bracket, small business owners may actually be better off by paying themselves only enough dividends each year to fund their current consumption and retaining any surplus funds inside the corporation, where the funds could be invested and the personal tax deferred. By minimizing the taxable dividends paid to you in a year, you are reducing your personal taxable income and minimizing the tax impact.

Pay family members a reasonable salary

If you are self-employed and your spouse and children help out in the business, consider paying them a reasonable salary for services rendered. Salaries or wages paid to them will reduce your net business income which would be taxable to you personally. This is a great income-splitting strategy that may save tax for your family if your children or your spouse is in a lower tax bracket than you. In addition, a salary or bonus is considered earned income for the purposes of generating RRSP contribution room and pensionable earnings for CPP/QPP.

If your business is incorporated, any remuneration you receive from your corporation is taxable to you, even if you end up using your after-tax proceeds to pay household expenses. Consider employing your family members and paying them a salary that is reasonable based on the services they are performing. The same household expenses may be paid using income taxed at a much lower rate and this can save your family money.

Pay dividends to adult family members

Consider paying dividends from corporate earnings to your spouse and adult children who are shareholders. If they are in a lower tax bracket this may minimize the amount of taxable income subject to the new Ontario tax bracket. Canadian dividends are taxed at a lower rate than salary, however dividends will not create RRSP contribution room or CPP/QPP pensionable earnings. Also, unlike salary, dividend payments do not have to be tied to the services performed in the business. Dividends that are paid out to benefit related minor children are taxed at the highest marginal tax rate under the "kiddie tax" rules.

Individual Pension Plans

If you are a business owner or an incorporated professional you may be familiar with the concept of an Individual Pension Plan (IPP). An IPP is a registered defined benefit pension plan sponsored by an employer, usually for one individual and, in some cases, for that individual's spouse if the spouse also works for the company. It is an alternative to an RRSP that enables your company to make larger tax-deferred annual contributions than would be permitted to an RRSP. These contributions are tax deductible to your corporation and can help provide additional pension income but without the necessity of paying you additional salary from your corporation which may expose you to a higher taxation as a result of the proposed increase to the top Ontario tax rate.

IPPs may provide a number of advantages. Contributions increase with the age of the plan holder and allow greater contributions than those permitted for an RRSP. An employer can also make an additional contribution at the time of the plan holder's retirement. In addition, if the investment earnings in the plan are lower than expected, it may be possible to make additional contributions to address the deficit, depending on the province or territory where you live. Assets in an IPP may also offer creditor protection and typically suit business owners, incorporated professionals or key employees who are age 40 or older and earn an annual salary of at least $100,000.

Plan now so that opportunities to minimize tax are not overlooked

Tax planning should be an ongoing, dynamic process so that opportunities to minimize tax are not overlooked. Whether you are able to take advantage of the tax planning opportunities discussed in this paper, or pursue other tax planning strategies, advance planning is the key to success. Now is a good time to review your tax planning to address changes to the law and to your personal situation.

Focusing on tax planning in the short and long term is a significant part of an overall financial plan. A comprehensive financial plan prepared for you and your family can address all aspects of your financial affairs, including cash and debt management, tax and investment planning, risk management, and retirement and estate planning. It can help ensure that no aspect of your overall financial picture is overlooked and in doing so, will help identify potential strategies to minimize the potential impact of the new Ontario tax bracket on your family's wealth.

RBC works with individuals, business owners and their independent legal and tax advisors to understand your personal goals. Drawing on the depth of experience that members of our team have developed as financial, taxation and legal professionals, we are able to present strategies that are appropriate for your personal situation. Reaching your goals often requires an interaction of strategies that minimize taxation, provide sufficient retirement income, safeguard your wealth, and provide for the effective transition of assets between generations.

› Speak to your tax advisor if you would like more information on tax planning strategies.