# CORPORATE INCOME TAX OPTIMIZER

Empowering Small Business with Smart Tax Strategies

New Client

**Prepared by:**

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## Province: Ontario

| Corporate Tax Rates | Federal | Provincial | Combined | Part IV Tax Rate |
|---|---|---|---|---|
| ABI Eligible for Small Business Deduction (SBD) | 9.00% | 3.20% | 12.20% | |
| ABI at Higher Corporate Tax Rate | 15.00% | 11.50% | 26.50% | |
| Passive Investment Income | 38.67% | 11.50% | 50.17% | 38.33% |

| Personal Marginal Tax Rates | Ordinary Income |
|---|---|
| New Client | 53.53% |
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| | |

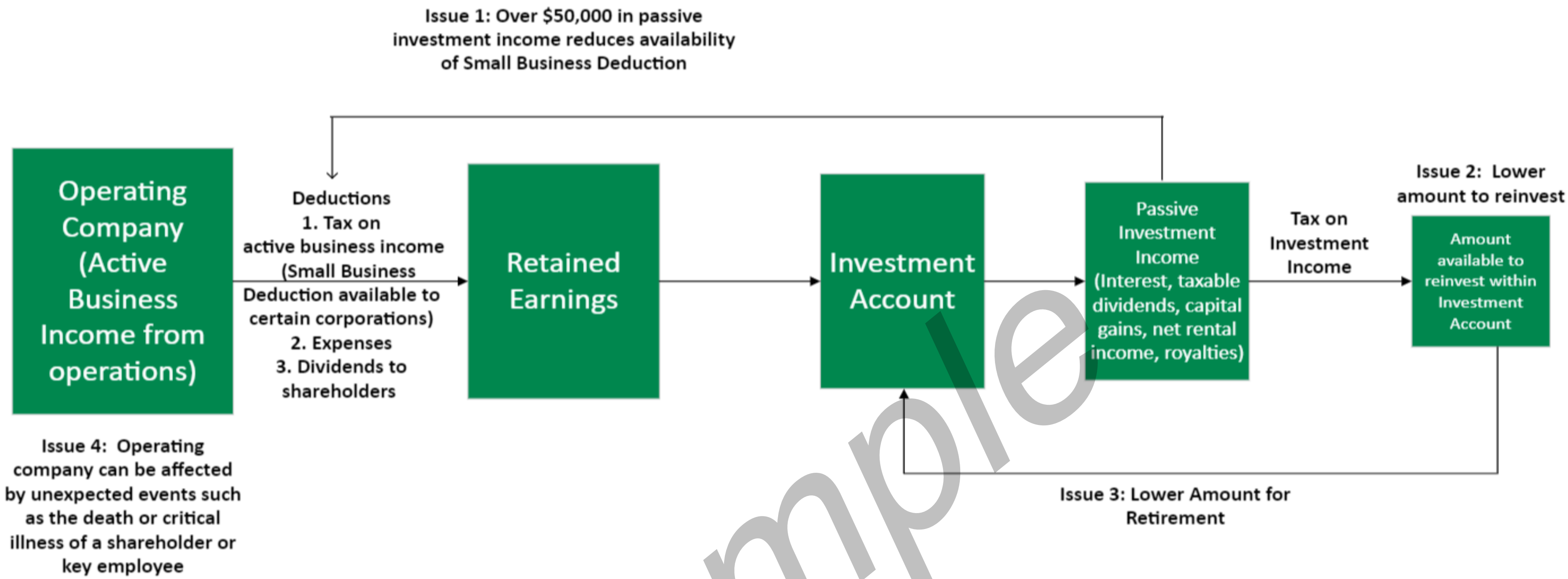
| Corporate Active Business Income (ABI) | ABI in Previous Taxation Year (Net of expenses) ($) | Projected Annual Business Growth | Net ABI Transfer to Passive Investments |
|---|---|---|---|
| ABC Inc | 600,000 | 12.00% | 25.00% |

| Investment Portfolio | Allocation | Current Value ($) | Projected Rate of Return | MER | Annual Turnover |
|---|---|---|---|---|---|
| Short-Term Investments | 5% | 125,000 | 2.30% | NA | NA |
| Fixed Income Investments | 35% | 875,000 | 3.20% | 0.00% | NA |
| Equity Investments | 60% | 1,500,000 | 6.20% | 0.00% | 10% |
| **Total** | **100%** | **2,500,000** | | | |

Returns from equity investments are 33.33% from dividends, 66.67% from capital gains.

| Other Passive Income | Net Rental Income/Royalties ($) | Other Income Growth |
|---|---|---|
| Previous Year's Net Rental Income / Royalties | 50,000 | 10.00% |

# YOUR CURRENT SITUATION






ABC Inc is a Canadian-controlled private corporation (CCPC) according to the *Income Tax Act* (Canada). The revenue generated through regular business operations is active business income (ABI). Your corporation generates more revenue than is required to cover the expenses of day-to-day operations. When ABI exceeds expenses, your corporation will have to pay corporate tax. Your corporation is eligible for the small business deduction (SBD) to reduce the corporate tax payable on your corporation's ABI. The amount remaining after paying taxes and dividends to shareholders is the corporation's retained earnings (RE). The retained earnings can be used to reinvest back into the business to finance growth or improve operations and to invest in taxable passive investments through the corporate investment account.

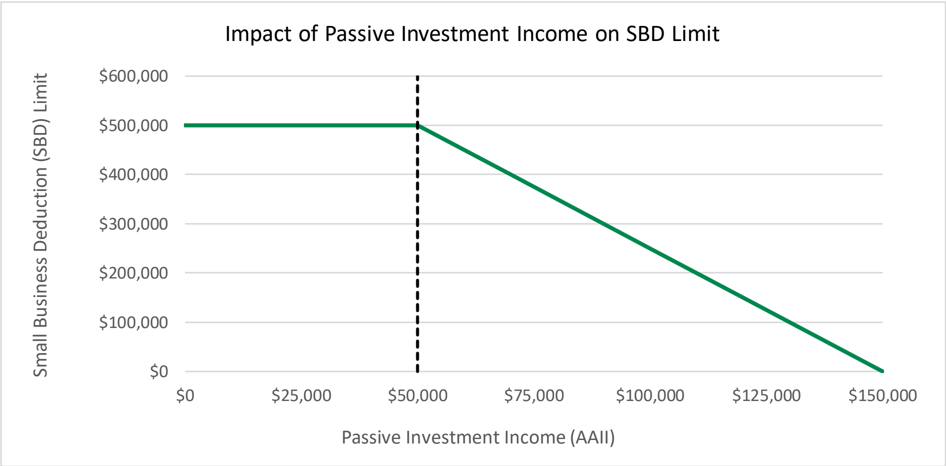
When the CCPC decides to invest the retained earnings through a corporate investment account, the investments could generate passive investment income such as interest, dividends, capital gains, rental income or royalties. These kinds of passive investments income are included in the calculation of adjusted aggregate investment income (AAII). The passive investment income is taxed at a higher rate than ABI. A portion of taxes paid is added to the refundable dividend tax on hand (RDTOH) account. When the CCPC pays dividends to its shareholders, it can receive a refund of taxes paid on investment income. Essentially, RDTOH is a mechanism that integrates the personal and corporate tax systems to avoid double taxation. See Appendix for more details on the RDTOH account.

## Corporate planning issues

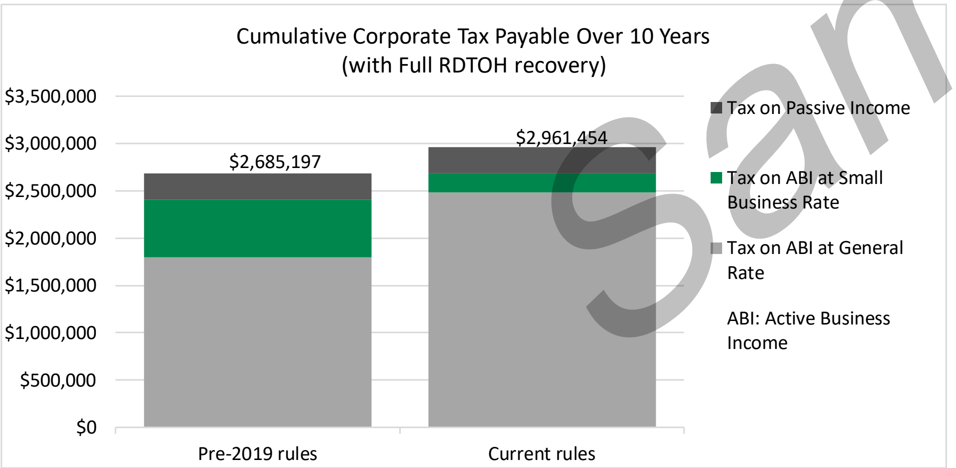
### Issue 1: Your passive investment income challenge

The federal government's introduction of the passive investment income tax rules may expose your corporation to more tax now and in the future. Starting in January 2019, your corporation's access to the SBD will gradually reduce whenever the previous year's passive income of your corporation and any associated corporations is over $50,000 per year. The SBD limit is reduced by $5 for every $1 of passive investment income exceeding the $50,000 threshold. Once your corporation's previous year's passive income reaches $150,000 per year, none of your corporation's ABI will qualify for the small business tax rate. This can have a significant adverse effect on your corporation's annual tax bill.

The following graph shows the effect on a corporation's federal small business deduction (SBD) level as its passive investment income increases.




Based on the "Data and Assumptions" section, the cumulative tax increase for your corporation over a 10-year period with full RDTOH recovery is $276,257.



### Issue 2: Lower amount to reinvest

When your corporation's passive investment income exceeds the $50,000 threshold, access to the SBD is reduced. Your corporation will have to pay tax at a higher rate on its growing ABI. This increased tax obligation ultimately means that less money will be available for your business succession, reinvestment and retirement needs.

### Issue 3: Lower amount for retirement

The higher tax rate imposed on passive investment income closely approximates the average top marginal tax rate for individuals, acting as a deterrent to using CCPCs as tax deferral vehicles. Paying more in tax reduces the corporation's funds for reinvestment, which can mean less money will be available for a shareholder's retirement needs.

| Tax Rates on Investment Income earned by CCPCs (%) | |
|---|---|
| Federal Rates | 38.67% |
| Ontario rates | 11.50% |
| Combined Federal and Ontario tax rates | 50.17% |

### Issue 4: Unexpected events affect corporate operations

Future operations could be adversely affected by unexpected events that happen to a shareholder or key employee such as death or critical illness.

### A. Impact of Death

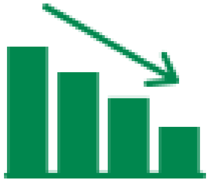
1. Ownership Changes: A shareholder's death may trigger ownership structure changes as shares are transferred to heirs or sold to existing shareholders or a third party.
2. Leadership Disruption: The death of a shareholder or key employee can leave a gap in experience and expertise which can hinder decision making and strategic planning for the corporation.
3. Financial Stress: The CCPC may experience financial stress if day-to-day activities are postponed or cannot be completed, business opportunities are lost, or the corporation's suppliers and creditors are concerned about payment. In addition, the sale or other disposition of the deceased's shares may reduce the corporation's market value.

### B. Impact of Critical Illness

1. Temporary or Permanent Absence: Depending on the severity, a critical illness may cause the temporary or permanent absence of a shareholder or key employee, resulting in operational inefficiencies and unfulfilled responsibilities.
2. Decision Making: Corporate decision making may be affected if the individual plays a significant role in everyday operations of the corporation.

# CORPORATE INCOME TAX OPTIMIZER BENEFITS

The Corporate Income Tax Optimizer is a flexible planning approach that will assist you and your advisor[1] in assessing potential effects of the passive investment income rules on your corporation and how the purchase of corporate-owned life insurance and critical illness insurance products can provide the following benefits:



Reduced tax impact of the passive investment income rules due to reallocation of retained earnings into premiums

Non-taxable proceeds in the event of critical illness

Liquidity for business operations and potential income at retirement for a shareholder or key employee



A well-planned reallocation of your corporation's investment portfolio to include corporate-owned insurance products can help to reduce the impact of the passive investment income rules.

This approach can enhance your corporation's overall risk management arrangements in the event of the death, critical illness or retirement of a shareholder or key employee.

Consultation with your advisor and a review of your current situation are necessary to identify the solution or solutions that best fit with your needs and those of your corporation. As part of your planning process, integrating advice from legal and taxation advisors who are familiar with your situation is recommended.

1. For the purposes of this report, in Quebec, this refers to a financial security advisor registered with the Autorité des marchés financiers. This person is licensed to distribute Desjardins Insurance products or works on behalf of Desjardins Financial Services Firm Inc. In other parts of Canada, financial security advisors may be called financial services advisors or life and health insurance advisors, among other titles.

Your strategic options to minimize the impact of the application of the passive income rules include:

**Life Insurance**—both term and permanent—offers many advantages to a corporation and its shareholders. The non-taxable death benefit can provide liquidity upon the death of a shareholder or key employee, funding for a buy-sell agreement or a non-taxable dividend to a shareholder's estate to provide cash in the estate. The tax-deferred growth of accumulation savings inside a permanent policy can reduce your corporation's passive income each year while providing values that can be used for corporate needs during lifetime or to enhance the retirement income of a key shareholder[2].

**Critical Illness Insurance** can protect your corporation from financial losses due to the critical illness or untimely demise of a shareholder or key employee. Return of premium riders and benefits are available, depending on the product selected.

The **Executive Health Plan (EHP)** allows a shareholder or key employee to own a critical illness policy jointly with the corporation. As a part of this concept, the corporation will receive a non-taxable benefit if the shareholder or key employee is diagnosed with a critical illness or dies. If the shareholder or key employee remains healthy until the end of the needed coverage period, they will get a non-taxable health benefit[3].

**Additional corporate planning options:**

- You can acquire disability insurance, which can provide a monthly amount to replace your income or salary in the event of a disability. This can ensure that you are able to maintain your standard of living and continue to meet your financial obligations without having to deplete your savings. An amount may be payable upon death if you pass away while receiving disability monthly amounts.
- You can establish a defined benefit pension plan designed for one person[4], which can increase your retirement savings in a significant way. The plan contributions and administration costs are deductible corporate expenses. Like other registered pension plans, the assets held in the plan are protected from the corporation's creditors.
- You can reallocate a portion of your corporation's fixed income investments into tax-deferred investments, which can provide the potential for a higher return compared to a fixed-rate term investment. Timing of the taxation of the tax-deferred investment will depend on the options chosen by the corporation in consultation with its investment and other professional advisors.

Insurance premiums, contributions to pension plans for shareholders and deposits to the investment product or account will be financed by your corporation's surplus cash or by the reallocation of existing investment assets.



2. Consult your taxation advisor as the tax consequences of different lifetime uses of corporate-owned life insurance can vary.
3. In the case of an employee who is not a shareholder, the tax authorities may be of the view that the employee received a taxable benefit by virtue of their employment when the health benefit is paid. The determination of the value of this benefit is a question of fact and clients should consult with an independent taxation advisor in this regard.
4. Pension plans for shareholders must comply with the applicable provisions of the *Income Tax Act* (Canada) and the pension legislation for the province or territory where the sponsoring corporation is located.

# YOUR TAILORED CONCEPT SOLUTIONS

Here are the proposed concept solutions:

| Insurance | Corporation's Annualized Premium ($) | Insured's Annualized Premium ($) | Payment Period (Years) | Insured's Gross Salary/Bonus Increase ($) |
|---|---|---|---|---|
| 5 Pay | 200,000 | | 5 | |
| 10 Pay Estate Enhancer | 150,000 | | 10 | |
| 20 Pay Accelerate Growth | 100,000 | | 20 | |
| EHP 1 | 30,000 | 25,000 | 25 | 53,798 |
| EHP 2 | 50,000 | 50,000 | 10 | 107,596 |
| | | | | |

# TAX ON YOUR CORPORATION'S ABI (COMBINED FEDERAL AND PROVINCIAL TAX)

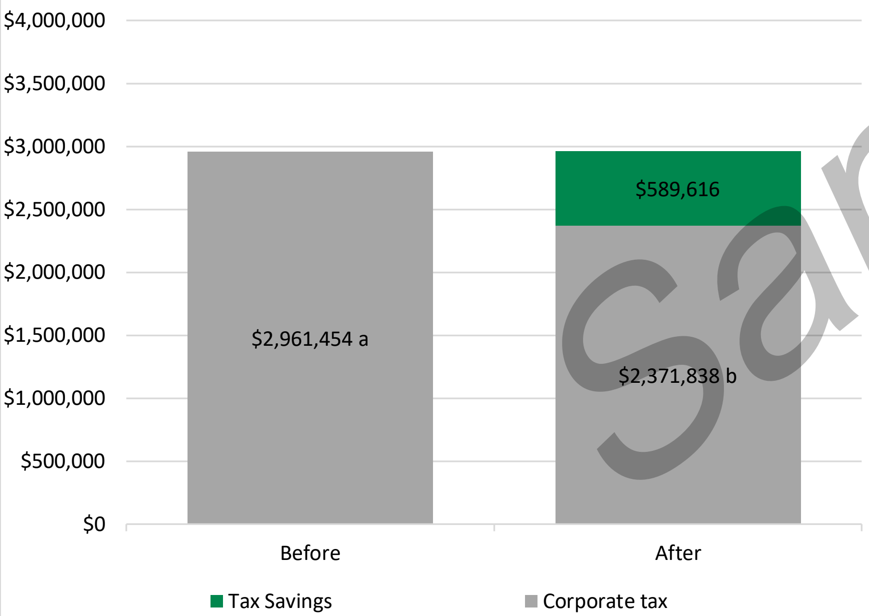
The scenarios below demonstrate the impact on tax savings and RDTOH after implementation of your advisor's recommendations outlined in the "Your Tailored Concept Solutions" section on page 8. The corporation's taxation advisors should be consulted on which scenario will meet the corporation's planning objectives over 10 years.

**Scenario 1 - Full RDTOH recovery:** Figure 1 shows what can happen over 10 years when the passive investment income from the corporate investment portfolio is paid out and RDTOH is recovered every year. The cumulative tax savings over 10 years would be $589,616 and the cumulative RDTOH recovered would be $370,519, resulting in an RDTOH balance of $0 at the end of the period.

**Scenario 2 - No RDTOH recovery:** Figure 2 shows the potential outcome when the passive investment income from the corporate investment portfolio is not paid out and the RDTOH is not recovered. The cumulative tax savings over 10 years would be $845,217 and the RDTOH balance at the end of the same period would be $371,880.

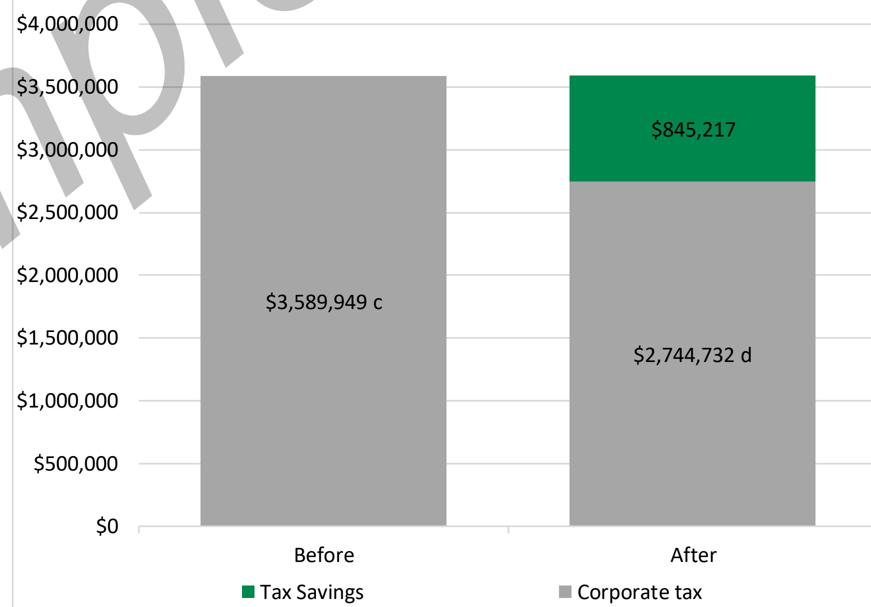
**Impact on Total Taxes after Implementation of Recommendations Over 10 Years**

**Figure 1**
**(Tax Savings of $589,616 and Full RDTOH Recovery of $370,519)**




a This amount is net of RDTOH recovered of $639,107
b This amount is net of RDTOH recovered of $370,519

**Figure 2**
**(Tax Savings of $845,217 with RDTOH Balance of $371,880)**




c This amount is with RDTOH balance of $630,843
d This amount is with RDTOH balance of $371,880

# IMPORTANT INFORMATION

This **Corporate Income Tax Optimizer Concept** presentation is only complete if it contains all the pages. It must be accompanied by the complete illustrations of the appropriate life and critical illness insurance products prepared within 30 days of the date of this concept presentation as they are an integral part of the document.

This concept presentation was prepared for information purposes using personal and financial information provided by you and your corporation. It is important that this information is as accurate as possible as even small discrepancies in this information can have an impact on any recommendations made. The concept presentation is to be used only to demonstrate the potential tax benefits arising from the implementation of one or more of the financial product solutions as set out in the concept presentation based on information provided by you and your corporation and specified assumptions taken from the attached life and critical illness insurance product illustrations. It is not an insurance offer or contract, nor is it a legal or tax opinion.

The benefits shown in the concept presentation are based on a set of assumptions which **may or may not** be achieved depending on actual performance. Assumptions which may be affected by actual experience may include, without limitation, one or more of the following, if applicable: the amount and timing of deposits to life or critical illness insurance policies; tax rates; interest rates; performance credit scales; inflation; the tax treatment that applies to the life and critical illness insurance policies; income, dividend and capital gains taxes and tax rules regarding passive income. If actual experience is less favourable than that shown in the concept presentation and the attached life and critical illness insurance product illustrations, additional deposits may be required by the client to maintain the level of life insurance product benefits. Please refer to the attached life and critical illness insurance product illustrations for limitations on policy values and guarantees.

If an Executive Health Plan (EHP) is part of the concept presentation, Desjardins Insurance's comments regarding tax implications in this concept report are based on the assumption that the corporation pays the portion of the premiums related to the critical illness and death coverages only for the coverage period it needs and the shareholder or key employee pays the portion of the premiums related to the health benefit coverage, plus any portion of the critical illness and death coverages that extend beyond the coverage period required by the corporation. Desjardins Insurance's comments are based on legislation and administrative policies published by the tax authorities as of June 2021 but do not cover every possible situation. These comments also only pertain to the tax rules that apply to the EHP concept. Desjardins Insurance expressly reserves the right to amend its comments, without notice, with respect to the tax implications outlined above in the event of any such change in legislation and administrative policies. Since Desjardins Insurance cannot guarantee the tax implications of the EHP and cannot be held liable for any tax consequences that arise from the corporation paying the portion of premiums for critical illness and death coverages or from the payment of a benefit to the beneficiary, clients should consult their independent legal and taxation advisors before setting up an EHP.

All comments related to taxation are general in nature and are based on legislation and administrative policies published by the tax authorities as of the date of this concept presentation but do not cover every possible situation. Future changes to tax legislation and administrative policies may affect this information. Desjardins Insurance expressly reserves the right to amend its comments, without notice, with respect to the tax implications outlined above in the event of any such change in legislation and administrative policies. While reasonable efforts have been made to ensure its accuracy and the information contained herein is presented here in good faith, errors and omissions are possible. Persons who are not residents of Canada or are resident in Canada but are citizens of another country, may be subject to different tax rules in Canada and may also be subject to taxes levied in jurisdictions other than Canada. For specific situations, you should consult the appropriate taxation, accounting or legal expert.

Desjardins Insurance does not intend to provide taxation, accounting or legal advice to clients or potential clients. The information contained in this concept presentation is not intended to offer such advice, nor is it to replace the advice of independent taxation, accounting and legal professionals. For individual circumstances, consult with your taxation, accounting and legal professional advisors.

The use of this concept presentation does not guarantee acceptance of the coverage amount or amounts applied for. The proposed insured must satisfy medical and financial underwriting requirements and must qualify for the coverage once the application has been submitted.

## Insurance

**Annualized premium:** The insurance policy offers a variety of premium payment options. The premium can be paid on a monthly, quarterly, semi-annual or annual basis. The annualized premium is the total amount of premium paid per year.

**Critical illness insurance:** This insurance provides a non-taxable, lump-sum payment if you are diagnosed with one of the critical illnesses covered by your policy. Depending on the policy features, you may be entitled to receive an advance on the coverage amount if you are diagnosed with a less severe critical illness. Riders available with critical illness insurance include various return of premium options.

**Disability insurance:** This insurance replaces your income if you are unable to work due to an accident or illness. During your total disability, you can receive a non-taxable monthly amount during the benefit period you chose. An amount may be payable upon death if you pass away while receiving disability monthly amounts. Disability insurance features and riders include partial disability benefits, future insurability option, return of premium options, regular occupation period extender and more.

**Executive Health Plan (EHP):** With this plan, you own a critical illness policy jointly with your corporation. Your corporation pays the portion of the premiums for the critical illness and death benefits for the coverage period. You pay the portion of the premiums for the health benefit. Your corporation will receive a non-taxable benefit if you are diagnosed with a covered critical illness or die. If you remain healthy until the end of the needed coverage period, you will get a non-taxable health benefit.

**Life insurance:** The insurance company guarantees payment of a non-taxable death benefit to the beneficiary upon your death. Many types of coverage are available to meet your needs.

## Taxation

**Active business income (ABI):** Generally consists of the main and incidental income that a corporation earns from a business source carried on in Canada, other than income from property, a specified investment business or a personal services business.

**Adjusted aggregate investment income (AAII):** AAII is used to determine the effect of passive investment income rules on a Canadian-controlled private corporation. It includes interest income, capital gains (net of allowable capital losses from the current year), net rental income, royalties and taxable dividends received by a corporation other than dividends received from connected corporations. Capital gains and losses from the disposition of active assets are not included in the AAII calculation. Calculating AAII is complicated and must be done each year to determine a corporation's eligibility for the small business deduction. (See below.)

**Canadian-controlled private corporation (CCPC):** A private corporation that is resident in Canada for tax purposes and not a public corporation. It must have been either incorporated in Canada or resident in Canada from June 18,1971 to the end of the tax year. A CCPC is not controlled directly or indirectly by one or more non-resident persons or by public corporations.

***Income Tax Act*:** The federal statute that governs taxation of the income of individuals, corporations, partnerships, trusts and estates in Canada. The provinces and territories also levy income tax. The *Income Tax Act* is amended on a regular basis.

**Net rental income:** Income less the eligible deductions received by an individual, corporation or trust from the rental of real estate or other property.

**Part IV tax:** Part IV of the Income Tax Act deals with the treatment of taxable dividends received by private corporations in Canada. The purpose of Part IV tax is to prevent individuals from earning Canadian source dividends through a corporation and deferring taxes on those dividends. This is possible because corporations are not taxed on dividends from other Canadian resident corporations.

# GLOSSARY

**Part IV tax:** Part IV of the Income Tax Act deals with the treatment of taxable dividends received by private corporations in Canada. The purpose of Part IV tax is to prevent individuals from earning Canadian source dividends through a corporation and deferring taxes on those dividends. This is possible because corporations are not taxed on dividends from other Canadian resident corporations.

**Passive investment income:** This generally consists of corporate earnings not directly related to the business source. Passive investment income can come from certain types of interest, capital gains, net rental income, royalties or dividends received by a corporation (and its associated corporations).

**Refundable dividend tax on hand (RDTOH):** RDTOH is a notional tax account in which the refundable tax paid by a private corporation on its investments and dividend income accumulates. The account is refundable when the corporation pays a taxable dividend to its shareholders.

**Royalties:** Monetary compensation to the owner of an asset for the use of intellectual property. Royalties can also be income from investments or a business. Royalties give investors access to a percentage of future income and periodic income from a corporation.

**Small business deduction (SBD):** The small business deduction is a corporate tax reduction for Canadian-controlled private corporations (CCPCs). The reduced tax rate is available on active business income up to the corporation's business limit. The first $500,000 of active business income is taxed at a lower rate at the federal level. The limit may be different in some provinces. It is reduced by $5 for each $1 of passive income exceeding $50,000.

**Small business limit:** At the federal level, the limit is $500,000. The small business deduction will begin to be reduced under the new passive investment income rules.