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# COMMENT

Number 256 – JULY / AUGUST 2009

## Creating Long-Term Security

The media headline proclaiming that the "world has changed financially" is no scholarly observation. It is, however, an important observation that should act as a catalyst from a financial planning perspective.

Without a doubt, most individuals will have experienced some impact of the overshadowing recession faced by countries around the world. A face-to-face discussion with a trusted financial advisor is an important step that can lead to a more secure future.

For individuals caught in the economic downturn through the loss of employment, a capable financial advisor can play a valuable role in devising a financial plan to get you through the short term. Having an independent person help to assess options and analyze costs can create a surprising level of comfort. Your financial advisor understands the tax implications associated with different alternatives and can provide input into the long-term opportunity costs. Whether you are borrowing from your line of credit, accessing savings in your RRSP or non-registered account or even considering the sale of your home, each alternative has benefits and costs that your advisor can help put in perspective.

For those who continue to feel secure in their current employment circumstances, it is an ideal time to reassess your contingency and retirement plans.

Contingency planning is more important than ever. In the event of a disability or unplanned change in employment circumstances, your ongoing family needs will remain but your financial resources could dry up pretty quickly. While some individuals may be eligible for disability benefits or employer-sponsored sick days, many individuals do not have this assurance. A disabling illness or injury is not the only event that could intrude on your income – what about the possibility of a layoff or job loss? While severance benefits may lower the financial intrusion of an unplanned layoff, employers are seldom generous and it is taking longer than ever for individuals to find alternative employment. Regardless of the reason for the loss of family income, it is critical that one plan in advance in order to minimize the potential crisis.

To begin this assessment, ask yourself – what level of savings do I need to live worry free for a three- to 12-month period? Be honest and keep in mind your mortgage, property taxes, condominium fees, car payments, utilities, groceries and even prescription and dental costs. If you are really not sure, track your spending for a two-month period by writing down all expenditures. This can be a worthwhile exercise to assess your ongoing needs. Even more importantly, it can help you look for areas where fine-tuning of spending habits can shift expenses into savings opportunities. For example, there may be items on which you are spending far more money than anticipated and a shift in habits could create a savings opportunity without much disruption.

It is no surprise that many families live month to month and have limited savings, so when unforeseen circumstances arise, the impact can be dramatic. In more recent years, the availability of a line of credit, often secured on the value of one's home equity, has been used as a supplement or even an alternative to a contingency savings program. Unfortunately, the changing economic circumstances have meant longer periods of unemployment and even the situation of two spouses facing simultaneous income disruption. At the same time, many financial institutions have reduced even pre-approved lines of credit in the current tight credit environment. As such, relying only on a line of credit can be problematic. Assuming the credit remains available, you need to make minimum interest payments and, without income, this can be difficult. As well, steady borrowing on a line of credit can build up to a substantial outstanding balance and become daunting. It is far easier to devise and follow a savings plan while employed for those unforeseen contingencies.

Retirement is another area where planning can be of crucial value. Perhaps you are relying on a defined benefit pension plan to support your retirement that is several years off into the future. Some individuals in this circumstance feel unaffected by the recent downturn in the market values of stock assets; after all, managing

the pension plan is the employer's responsibility, isn't it? Maybe. However, in these "changing times," the pension burden associated with a defined benefit plan can be overwhelming for employers who may look for alternatives – whether planned or unplanned. The one person who can help assure your future security is you – good planning for retirement will include other types of savings, so one is not completely reliant on a defined benefit pension plan.

For those in a money purchase type of arrangement, whether it be a defined contribution pension plan or RRSP, the investment risk remains with the individual. And, for many, the dramatic decline in the stock market has no doubt had some impact. This is an ideal time to work with your investment advisor to ensure the balance and asset mix of your registered and unregistered savings reflects your current circumstances and risk tolerances.

Understanding your circumstances and implementing a plan that puts you on the road to a more secure future will provide long-term financial security and peace of mind.

I/R 5601.00

## Proposed Changes To The CPP

The Department of Finance released an information paper on proposed changes to the Canada Pension Plan (CPP) on May 25, 2009. The changes are as a result of the regular three-year review of the program and are designed to improve flexibility, coverage and fairness. It should be noted that these proposed changes will not impact any individual already receiving CPP retirement benefits.

The first change proposed is to drop the work cessation requirement for those individuals taking their CPP retirement benefit early (prior to the normal age 65 retirement). Currently an individual must stop work for at least two months before applying for early retirement benefits. The proposed change will make it easier for individuals to enter retirement on a reduced work basis without having to formally give up their job.

The second change being proposed is to increase the dropout period that is used in the calculation of the average career earnings. Currently, the dropout period is 15 per cent or about seven years for an individual who has worked continuously from age 18 to age 65. The proposal is to increase this period to 16 per cent (about 7.5 years) in 2012 and 17 per cent in 2014. This change will allow an individual to remove his or her eight lowest years from the calculation when determining average career earnings.

The third change being proposed is to require individuals who have taken early retirement and continued or returned to work to continue to contribute to CPP. These contributions will build their retirement benefit at the rate of 1/40th of the maximum pension amount per year of contribution. These contributions would continue until the individual reaches age 65 or ceases employment, whichever occurs first. The change will help early retirees to continue to build their retirement benefit and therefore build a better hedge against inflation.

The fourth and last change proposed is to alter the adjustments for early and late retirement to better reflect the actuarial reality of today. Under the present system (which has not changed since 1987), an individual's retirement benefit is reduced by 0.5 per cent for every month prior to age 65 their retirement benefit begins; for a 60-year-old, this means a permanent 30 per cent reduction. Late retirement is enhanced by 0.5 per cent for every month an individual postpones his/her retirement up to a maximum of age 70. The proposed change will gradually increase the early retirement reduction to 0.6 per cent for every month before age 65 to a maximum of 36 per cent at age 60. This increase will be phased in starting in 2012 and will be fully in place by 2017. Late retirees will be eligible for an enhancement of 0.7 per cent for every month they defer their pension to a maximum of 42 per cent at age 70. These changes are intended to improve the fairness of the system.

The proposed changes are affordable within the current CPP contribution rate of 9.9 per cent on pensionable earnings up to the yearly maximum pensionable earnings (YMPE) ($46,300 for 2009).

Retirement planning needs to reflect an individual's entitlement to government benefits. The CPP system will be adjusted periodically to better reflect the economic times of the day and the planner needs to be aware of the implications.

I/R 3201.01

# Income Splitting With Children

Income splitting within the family unit can lower the overall tax bill of the family and therefore create more after-tax income. Income splitting with children can benefit the family by having the children rather than the parents pay tax at a lower marginal rate on the income required to support their needs. However, the federal Income Tax Act contains several anti-avoidance provisions that limit a family's ability to split income. The major ones are the "kiddie tax" and the attribution rules.

**Kiddie Tax**

The so-called "kiddie tax," also known as the tax on split income, is a special tax introduced in 1999 to attack certain income-splitting arrangements and is levied on a specified individual's split income. Split income is defined to include taxable dividends received on shares of a private company, income allocated from a partnership where it can be reasonable to assume that the business activity is carried on by a parent or allocations from a trust that could reasonably be assumed to be from taxable dividends from a private company or business income generated by a related person of a specified individual.

A specified individual is defined to mean a person under the age of 18 throughout the year, who is a resident of Canada throughout the year and has a parent who is a resident of Canada at some time during the year. This means that the tax does not apply to adults, non-resident children or resident children whose parents are non-residents.

There are some exclusions from the kiddie tax. It does not apply to income from property acquired as a result of the death of a parent. In addition, the kiddie tax does not apply to income from property acquired because of the death of any individual if the child is enrolled as a full-time student in a post-secondary educational institution during the year or if a claim is being made for the disability tax credit for the child. Both parents may want to consider bequeathing shares of their private company in trust for their children because this can provide an income splitting opportunity should one parent die while the children are still minors (since kiddie tax will not apply to such an inheritance).

The kiddie tax applies the top marginal tax rate for the child's province of residence to the total split income, regardless of the child's or parent's actual marginal tax rate, so it can be more devastating that the income attribution rules that apply to passive investment income. Apart from the dividend tax credit and foreign tax credit, there are no other credits (such as the personal exemption amount) or deductions available to the child to reduce his or her kiddie income tax liability. With kiddie tax in place, there is no benefit whatsoever from splitting this type of income.

Kiddie tax is targeted towards incorporated and unincorporated businesses where one or both of the parents are the driving force behind the business activity, but it can even catch junior entrepreneurs who incorporate while minors, although the dividend income is attributable to their own efforts alone.

**Transfers and Loans of Property**

Property can be gifted or lent either directly to a minor child or indirectly with the use of trust for the benefit of a minor child. (Note, however, that a loan to a minor is unenforceable at law.) Under the attribution rules, the income from the transferred property will be taxed in the hands of the transferor. While attribution will apply to income earned by the child or properly distributed to/allocated to the child from the trust, this applies only to interest and dividend income, but not capital gains. Capital gains will be taxed in the hands of the child with no attribution, but there is an important caveat – tax law cases have established clearly that capital gains will be attributed back to the parent where there is no formal trust and where it appears the donor or lender has a possibility of control over the funds.

Attribution of income from gifted or lent property applies to an individual's child or grandchild under the age of 18 throughout the year and an individual's niece and nephew also under the age of 18 throughout the year.

Also caught by this rule are loans or gifts that are used by the child to repay bona fide investment loans already in existence.

So-called "second generation income" is not subject to attribution. This means that if the child or trust were to track the reinvestment of income, the income earned on the reinvested income would not be attributed.

An exception to the attribution rule is where the loan bears interest at least equal to the prescribed rate in effect when the loan was incurred and the interest on the loan is paid within 30 days of year-end every year. That interest is taxable to the transferor. If the interest payment is even one day late or is not paid, the loan arrangement will be forever offside and the attribution rules will apply.

Income splitting is a very attractive objective because the overall tax cost to the family will be reduced. However, careful planning is critical to consider the anti-avoidance provisions to ensure that the taxpayer's objectives will be met.

I/R 2500.13

# Understanding Flat Tax

Someone once said that the art of taxation is like pulling the feathers from a goose – you must take the maximum amount of feather with the least amount of hissing. The debate over tax rates is very similar. Which is better – a flat tax or a marginal tax? And which is better for the government or fairer for taxpayers? Heightening this debate is the Ontario government's opposition party, which is discussing changing the system in Ontario to look more like that of Alberta.

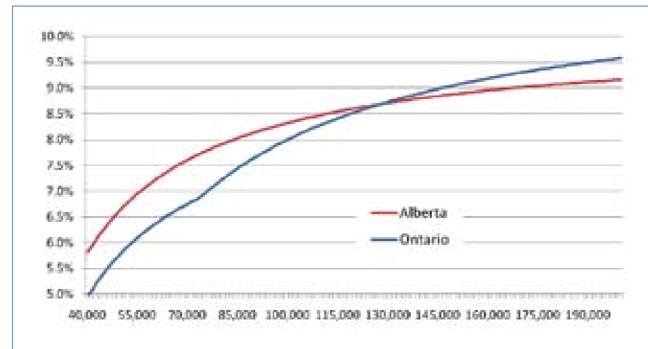
Proponents argue that a flat tax encourages the wealthy to make more money because the tax grab on the next dollar earned is not that onerous. A flat tax could act as a stimulus to the economy and create more prosperity for everyone.

The advantage of the marginal rate system is that wealthier taxpayers pay a higher portion of their additional income in taxes. This system shifts the tax burden from the poorer to the wealthier members of society.

However, the debate cannot be simply over tax rates because the lower income taxpayers can be protected through the use of exemptions, deductions and/or tax credits that make a given amount of income tax free. Credits available to taxpayers include the personal amount, married amount, dependant amount, age amount, disability amount, etc. The government can use exemptions, tax brackets and tax rates to achieve virtually any desired distribution of the tax burden.

The following graph compares the total provincial taxes paid as a percentage of taxable income for a single taxpayer in the provinces of Ontario and Alberta. Under the current 2009 regime, Ontario has three tax rate brackets – 6.05 per cent, 9.15 per cent and 11.16 per cent – and a personal exempt amount of $8,881. Alberta, on the other hand, has only one tax rate of 10 per cent, commonly referred to as a flat tax, along with a personal exempt amount of $16,775. No other credits or exemptions are factored into the following graph.

For 2009, the federal government has four tax rate brackets: 15 per cent, 22 per cent, 26 per cent and 29 per cent with a personal exemption of $10,320. However, because federal income tax rates are the same for taxpayers in every province, these federal percentages are not reflected in the graph below.




The graph shows that the overall provincial income tax rates in Ontario and Alberta are very close throughout the range of taxable income shown, despite the fact that these provinces apply different tax strategies. Ontario offers a tax rate that is one per cent lower than Alberta at the $40,000 income bracket. When reaching the $200,000 level, Ontario is about ½ per cent higher than Alberta.

Individuals can debate as to whether one system is better than another. The answer lies within your personal perspective and the direction of Canadian tax policy. While individuals will have a preference depending upon their personal circumstances, Canadians will benefit most when the slope of the tax line is carefully designed to achieve efficiency and fairness for every taxpayer.

I/R 7401.00

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Publication Agreement # 40069004

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