BMO Nesbitt Burns

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# Do you have a retirement game plan?

Life is all about transitions: graduation, starting a family, changing jobs, moving to a new home, raising children and, eventually, retirement. While many of us successfully negotiate these transitions, retirement can pose the greatest challenge. People often feel an initial sense of loss when they retire, followed by a period of re-orientation, then growth and, later, adaptation to their changed situation.

There are many reasons why people retire. According to a survey by BMO Wealth Management, 42% of Canadians would consider retiring when they're at the right age or stage of life or 23% would wait until they are financially able. Meanwhile, 27% of those who have already retired did so for health and family reasons while 14% retired when they were financially able.

While the average age at which Canadians retire has been slowly increasing over the last two decades – from 62.0 years in 1995 to 63.3 years in 2014, according to Statistics Canada. The BMO survey reveals that most retire between 55 and 64. They are excited, optimistic and prepared for this new life stage, with 64% having given at least some thought to the non-financial aspects of retirement.

## How to retire successfully

Of course, retirement is not an everlasting vacation. Almost three-quarters (69%) of BMO respondents believe that being engaged or interested in daily activities is important when transitioning to retirement as is leading a purposeful and meaningful life (62%) and having a positive outlook toward the future (59%).

Dr. Amy S. D'Aprix, an internationally renowned expert on aging-related lifestyle issues and a BMO life transition expert, stresses there are three keys to successful retirement:

- **Purpose** – The need or drive for something to get out of bed in the morning gives life a sense of meaning.
- **People** – Studies have shown that having positive and nourishing social interactions are linked to better health and longevity.
- **Perspective** – Having a good attitude towards the future and believing you can succeed help build resiliency in retirement.

"The most successful people about to transition into retirement are those who give thought to the question, 'What will I do after leaving work?' because planning in advance makes this transition easier," explains Dr. D'Aprix.

## Let's connect

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### The Game Plan

So what should one expect in retirement? According to the survey, most Canadians (73%) would seek recreation or travel upon retirement, and many would volunteer (46%), learn/educate (43%), work/consult (31%) or pursue their "bucket list" (31%). That said, it's important for people to ask themselves some hard questions. Who do you picture yourself with in retirement? What do you see yourself doing? Where do you plan on living? How will your health impact your retirement plans? Some of these questions may not be easy to answer, but with the assistance and resources of a financial professional it will be possible to picture the details of your planned retirement.

Financial preparation is a key component in making an effective transition to retirement, and that's where a game plan comes into play. What would happen to your retirement plan if you became injured or critically ill and could not work full-time, or at all? Dipping into your retirement savings early could derail your plans.

For a retirement plan to be robust, it is necessary to understand your cash flow requirements and to ensure that there are sufficient resources available to cover both day-to-day expenses and other discretionary expenses or other financial goals.

### Different strokes for different folks

Not everyone looks at retirement the same way. When asked what retirement means to them, the BMO survey revealed several responses. These included resigning from a principal career (46%), eligibility for employer or government pension (37%), being a certain age (35%), permanently stopping working (35%), and achieving financial independence (34%). Most notably, retirement means "freedom" for most Canadians (62%) and is even prominent among those who have already retired, with (68%) ranking it at number one.

Retirement can also be seen as the next chapter in your life, or – in work terms – as your next role. Working after exiting a career or continuing to work into retirement, can also help fill the financial void once retirement starts. Developing a financial plan with the assistance of a financial professional can help you best decide how to plan for and meet future financial needs.

It is important that we work together to plan a retirement that meets your individual goals. Let's discuss and please let me know if you would like a copy of the BMO Wealth Management report titled *Retirement – what's your game plan?*

# Personal holding companies – taxation of investment income

Many individuals hold investment portfolios in a personal holding company (PHC).[1] It is important for these investors to understand the various tax implications of earning investment income through a holding company. Tax implications can be quite different from owning investments personally, because a corporate structure introduces a number of other considerations. Most notably, since a PHC introduces an additional level of tax (i.e., corporate tax on the income earned by the PHC), in addition to any personal income tax on distributions from the PHC, double taxation of the underlying income may result.  However, the system of "integration" within the tax legislation seeks to address these concerns, which creates some additional nuances.

### Taxation of Investment Income in PHCs

The investment income earned on assets in a PHC is taxed initially in the corporation, which must file an annual corporate income tax return. Given that corporate tax rates are generally lower than personal tax rates, special refundable taxes are imposed on investment income of private corporations in order to limit the ability of individuals to defer taxation by holding investments in a private corporation. However, in light of the recent 4% increase in the top federal personal tax rate, the "integration" tax system for private corporations (described below), which seeks to ensure consistency in taxation between individuals earning investment income personally or through a private company, will also be amended to ensure its effectiveness with this new top personal tax rate. In particular, increases have been proposed to the (refundable) corporate tax rates on investment income and the rate at which corporate taxes are refunded from taxable dividend payments, effective January 1, 2016.[2]

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| Province | Income Type | CCPC Corporate Tax Rates % | Top Marginal Personal Tax Rates %[2] |
|---|---|---|---|
| **Alberta** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 48.00<br>31.71<br>24.00 |
| **B.C.** | Interest<br>Eligible Dividends<br>Capital Gains | 49.67<br>38.33<br>24.83 | 47.70<br>31.30<br>23.85 |
| **Manitoba** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 50.40<br>37.78<br>25.20 |
| **N.B** | Interest<br>Eligible Dividends<br>Capital Gains | 52.67<br>38.33<br>26.34 | 53.30<br>34.20<br>26.65 |
| **Nfld.** | Interest<br>Eligible Dividends<br>Capital Gains | 53.67<br>38.33<br>26.84 | 49.80<br>40.54<br>24.90 |
| **N.W.T** | Interest<br>Eligible Dividends<br>Capital Gains | 50.17<br>38.33<br>25.09 | 47.05<br>28.33<br>23.53 |
| **N.S.** | Interest<br>Eligible Dividends<br>Capital Gains | 54.67<br>38.33<br>27.34 | 54.00<br>41.58<br>27.00 |
| **Nunavut** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 44.50<br>33.08<br>22.25 |
| **Ontario** | Interest<br>Eligible Dividends<br>Capital Gains | 50.17<br>38.33<br>25.09 | 53.53<br>39.34<br>26.77 |
| **P.E.I** | Interest<br>Eligible Dividends<br>Capital Gains | 54.67<br>38.33<br>27.34 | 51.37<br>34.22<br>25.69 |
| **Quebec** | Interest<br>Eligible Dividends<br>Capital Gains | 50.57<br>38.33<br>25.29 | 53.31<br>39.83<br>26.66 |
| **Sask.** | Interest<br>Eligible Dividends<br>Capital Gains | 50.67<br>38.33<br>25.34 | 48.00<br>30.33<br>24.00 |
| **Yukon** | Interest<br>Eligible Dividends<br>Capital Gains | 53.67<br>38.33<br>26.84 | 48.00<br>24.81<br>24.00 |

[1] Combines both federal and provincial rates, including any rate changes in all 2016 federal and provincial budgets.
[2] Reflects the 2016 top combined individual marginal tax rates by province (updated for the new 33% top federal tax bracket). The rates apply to taxable incomes over $200,000 except that the thresholds are $220,000 in Ontario, $300,000 in Alberta and $500,000 in Yukon.
[3] Reflects corporate tax rate changes announced in provincial budget released February 2, 2016. Rate is effective April 1, 2016. Prior to this date, rate is 50.67% (interest) and 25.34 (capital gains).

The attached table entitled **Canadian Investment Income – Corporate Versus Personal Tax Rates**, reflects the impact of the higher 2016 corporate and personal tax rates on investment income for all provinces and territories. As you can see, the corporate tax rates in most jurisdictions are higher than the personal tax rates for investment income. Accordingly, the deferral benefit formerly associated with earning investment income through a holding company no longer exists in most provinces and territories.

## Integration

The concept of integration within the Canadian tax legislation seeks to make an individual indifferent between earning investment income personally, or indirectly through a PHC. This is a concern since an individual earning investment income directly pays only one level of taxation, whereas someone earning investment income through a corporation will pay tax at two levels (i.e., corporate tax on the investment income earned in the corporation as described above and personal tax on the distribution of the after-tax income to the individual shareholder; which is typically received as a dividend). Integration attempts to equalize the ultimate tax paid in either scenario. Through the use of various corporate tax accounts, such as the Capital Dividend Account (CDA) and Refundable Dividend Tax on Hand (RDTOH), as well as other tax mechanisms (e.g. dividend tax credit, and dividend refund), distributions from a PHC may result in a refund of corporate tax previously paid and/or will be subject to a reduced personal rate of taxation as partial compensation for this high initial corporate tax paid. This integration methodology seeks to equalize the aggregate amount of corporate and personal tax paid in a PHC structure, with the amount of tax paid for investment income earned personally that is subject to only one level of taxation.

However, the integration system is imperfect and may break down such that a pre-payment of tax or a tax cost from double-taxation may result; particularly on higher-taxed investment income. As a result of the recent tax rate changes effective in 2016, there is a tax cost of earning interest and capital gain investment income through a PHC for 2016 in all provinces and territories. Depending on the relevant provincial personal and corporate tax rates, this tax cost is generally 4 to 6 percent on interest income (2 to 3 percent on capital gains), and may be even higher on foreign investment income that is also subject to foreign withholding tax at source.

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## Eligible Dividend Income

With regards to earning Canadian dividend income, a corporation does not receive the dividend tax credit. Instead, a deduction for inter-corporate Canadian dividends is provided for a PHC but a federal refundable tax at 38.33% is typically applied on 'portfolio dividends' (e.g. dividends received from a portfolio of shares of Canadian public companies) such that this 38.33% rate will represent the upfront tax liability on Canadian public company dividends earned in the PHC. This compares favourably to the initial corporate tax rates on interest income (for example) but in some provinces/territories it may exceed the tax paid by an individual who received the eligible dividend directly. Note that in the absence of this 38.33% (part IV) tax, the inter-corporate dividend would escape immediate taxation in the PHC, so this (refundable) tax is levied to remove the tax deferral benefit that would otherwise apply in the PHC structure.

However, an investor earning income in a corporation will primarily be concerned with the aggregate corporate and personal tax liability of earning investment income through a corporate structure. An important concept therefore when earning Canadian dividend income is that the 38.33% refundable tax paid by the corporation can be refunded fully when a taxable dividend is paid to the shareholder of the PHC; the shareholder would then pay tax at their marginal tax rates on the dividend from the PHC. Accordingly, there is no net corporate tax in the PHC on Canadian dividend income such that the total (personal) tax on the ultimate distribution of the dividend to the PHC shareholder should be equal to the one level of tax paid if the dividend income was earned directly – which represents the full 'integration' of earning the dividend income through a PHC structure.

The integration system also applies to the taxation of interest and capital gains investment income earned in a PHC. However, there are additional complexities which can result in an ultimate tax cost described previously, when these types of income are earned through a corporate structure and flowed out to its shareholders.

## Summary

Although investment income tax rates for a PHC are generally similar to the top tax rates of an individual in that interest is taxed at the highest rates, capital gains at the lowest rates and Canadian dividends in between, the taxation is somewhat more complicated for a PHC earning investment income than an individual since there are two levels of tax to consider (personal and corporate) which creates additional nuances and complexities.

**The taxation of holding corporations is complex and the commentary provided herein is only of a general nature. For more information please contact your BMO NB Investment Advisor to obtain a copy of our concept sheet entitled "Understanding Personal Holding Companies" and be sure to consult with your tax advisor for more information and assistance in your particular situation.**

Footnotes:

1. This article is designed to briefly outline the Canadian tax implications for a Canadian resident individual earning investment income through a personal holding company (PHC). A PHC, often referred to as a "Holdco" or "Investment Holding Company", is not a defined term in the Income Tax Act, but rather a term adopted to describe a corporation which holds assets; typically income-generating investment assets. A PHC is usually a Canadian-controlled Private Corporation (CCPC) which is accorded special tax treatment under the Canadian tax legislation, including the refundable tax treatment of investment income described herein.
2. The Department of Finance's Notice of Ways and Means Motion released in December 2015, proposed that the refundable taxes and the related dividend refund rate be increased effective January 1, 2016 to reflect the proposed new 33-per-cent personal income tax rate. Specifically:
   - the refundable additional Part I tax on investment income of Canadian-controlled private corporations (CCPCs) will be increased by 4 percentage points (to 10.67 per cent from 6.67 per cent);
   - the refundable portion of Part I tax on investment income of CCPCs will be increased by 4 percentage points (to 30.67 per cent from 26.67 per cent);
   - the refundable Part IV tax on portfolio dividends received by private corporations will be increased by 5 percentage points (to 38.33 per cent from 33.33 per cent); and
   - the rate at which refunds are made out of a private corporation's pool of refundable taxes previously paid (known as "Refundable Dividend Tax on Hand") when it pays dividends will be increased by 5 percentage points (to 38.33 per cent from 33.33 per cent of dividends paid).

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