THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Control the type of income you earn to save tax dollars

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I remember taking my kids to a birthday party years ago. There was a magician there who was a very funny bald man. In one trick, he took an apple and balanced it on his head, then put on a top hat to hide the apple. He then instructed the kids to all shout "Grow me some hair!" A few seconds later, he took off the hat and there, sitting on his head, was a live rabbit. Come to think of it, maybe he said "grow me a hare" and not "some hair." I don't remember exactly.

Turning an apple into a rabbit was a good trick for the kids. As a taxpayer, turning highly-taxed income into lower-taxed income is an even better trick. This is what I call "disguising income," which is the fourth pillar of tax planning (see my introduction to the five pillars on Dec. 28, 2022). Let's look at five clever ways to disguise income to save tax dollars.

Set up a back-to-back prescribed annuity. Now that interest rates have risen, annuities – which make regular payments – can be an interesting investment because they can provide higher after-tax cash flow than other interest-bearing investments. Consider using some dollars currently invested in GICs, for example, and buy a prescribed annuity. A portion of each annuity payment will be taxable interest, but a portion will be a tax-free return of capital. A drawback is that your capital will be paid back over time so there won't generally be any left to leave your heirs. You can address this by using some of the additional cash flow from the annuity to buy a life insurance policy (alongside, or "back-to-back," with the annuity) that will pay out on your death, replacing all or some of the capital invested in the annuity.

Use a corporation to hold investments. If you move some or all of your non-registered investments to a corporation you'll convert personal income into corporate income. A reduction in personal income can reduce a claw-back of government benefits like Old Age Security. It can also minimize U.S. estate taxes on U.S. securities and minimize probate fees. In some provinces the tax rate on investment income in the corporation could be less than what you'd pay personally on the same income. There are other things to consider, such as a reduction to the small business deduction (if you're carrying on an active business) if the corporation's investment income is $50,000 or more in a year – so speak to a tax pro about it first.

Extract paid-up capital from your company. If you own shares in a private company you'll have something called "paid-up capital" (PUC). Your PUC is like a cousin to your adjusted cost base and represents an amount you can receive on a tax-free basis from your corporation. You can extract this PUC by redeeming shares, or by simply reducing your stated capital (see a tax pro for details). This is a way to "disguise" what might otherwise be taxable dividends as tax-free returns of capital.

Consider corporate-class mutual funds. While most mutual funds are set up as trusts, some are corporations. Technically, those corporations consist of multiple classes of shares, with each class representing a different type of mutual fund. Mutual fund corporations cannot distribute interest income, just capital gains and dividends – which are more favourably taxed. So, even a fixed-income corporate-class fund will not distribute interest. Any interest income earned by the funds is taxable inside the mutual fund corporation. But the expenses of operating the various funds are generally offset against the interest income earned, which minimizes the tax within the corporation. Be sure to consider returns net of fees when it comes to corporate-class funds. On an after-tax basis, they could make good sense.

Argue that it's a business. If you're doing something over and over again, you might argue that it's a business. Any income earned from that activity, then, could be considered business income and offset with expenses incurred to earn that income. I know a guy, for example, who has been personally lending money to others to earn interest income. He does this all the time. It could be argued that he's carrying on the business of lending money. So, his income could be considered business income and deductions could be available for things he's paying for anyway, like home office or vehicle costs. The rules are different for corporations, so speak to a tax pro about this.

Check out the table. It shows various types of income and which types are most tax-efficient.

TYPE OF INCOME	HIGH TAX	LOW TAX	TAX-FREE
Employment			
Salary and wages	•		
Bonuses	•		
Taxable benefits	•		
Stock options		•	
Non-taxable benefits			•
Investment			
Interest	•		
Foreign income	•		
Royalties	•		
Net rental income	•		
Canadian dividends		•	
Capital gains		•	
Return of capital			•
Capital dividends			•
Business			
Net self-employment income	•		
Shareholder loans - non-eligible uses	•		
Shareholder loans - eligible uses			•
Other			
Life insurance proceeds			•
Gifts or inheritances			•
Lottery winnings			•

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