

Non-deductible interest charges cost more

THE HIGH COST OF NON-DEDUCTIBLE INTEREST MAY SURPRISE YOU

Most people are aware that, wherever possible, it is far better to incur deductible loan interest and to pay off any non-deductible loans as quickly as possible. However, the extra costs of incurring non-deductible interest are not always evident.

Let us consider the implications of interest deductibility for a taxpayer in the highest tax bracket holding a loan or mortgage of \$200,000,

with a six per cent interest rate. Some people assume that they could offset the interest charges on such a mortgage if they had an investment that paid an equivalent six per cent per year in income.

Not so! If the interest on this \$200,000 mortgage is non-deductible, as it is on a mortgage for a private residence, an investment of \$200,000 would need to earn 10.9 per cent per year, with 4.9 per cent required to pay income taxes and the remaining

six per cent left to pay the mortgage loan interest.

On the other hand, if the interest is deductible, as it would be on a mortgage for a business property, the real cost is approximately 3.3 per cent after the income

tax saving is computed.

But are you sitting down? If you are in the highest income tax bracket, paying 18 per cent non-deductible interest on a credit card account, you would

need an investment paying off at approximately 32.7 per cent to offset the credit card interest charges!

Clearly, if you have any non-deductible interest costs, it is appropriate to review your borrowing strategies to see if any savings can accrue. And, obviously, your first step should be to ensure that there is no overdue balance on any credit card.

Generally speaking, it is usually possible to undertake maneuvers if

you have equity in either a business or investments, in excess of any associated financing. There are several strategies, some simple and some relatively complex, that might allow you, or a member of your family, to deduct interest that might otherwise be non-deductible.

Assume you have a personal mortgage of, say, \$100,000 and equity in your business in excess of this amount. It would be possible for you to sell \$100,000 worth of shares in the business to your spouse. Your spouse would arrange to borrow \$100,000 to purchase the shares. These funds would then be used to pay off the personal mortgage balance. Shortly afterward, your spouse's loan could be secured by a mortgage on the home.

Another example would be to assume that you have shares in a business that are worth \$100,000 and you wish to buy a sports car. You could arrange for your spouse to borrow the funds and buy some of the shares in the business from you. You could spend the money on purchasing the sports car and your spouse could claim a deduction

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for the interest paid on the loan. Although this example may sound aggressive, it is based on an actual question put to CCRA officials at a tax conference some years ago.

Both of the above examples may have the added benefit of allowing you to possibly utilize your lifetime capital gains exemption. Clearly, though, every case is different and it is essential to discuss your own situation in detail with your financial and legal advisors before implementing any changes.



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CLIENT QUARTERLY

WINTER 2004. VOL 2/#1

ORIGINALLY PUBLISHED IN 2004 BY FRANK MALINKA & UPDATED IN 2007

Is a 'Super RRSP' the best strategy for you?



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Are you a business owner, professional or highly-paid executive between the age of 40 and 71?

If so, you may be concerned about the amount of income you will have available to you upon retirement. You are not alone.

In fact, thousands of people invest heavily in a business or professional career early in life, skimping on the amount they set aside for retirement. Later, they discover that RRSP contribution limits make it impossible for them to catch up.

What can be done? Is there a way of contributing to more than just an RRSP to make your retirement plan work – and still benefit from a significant tax shelter?

Yes, there is. An Individual Pension Plan is a strategy that's been called a "super" RRSP. You get a high level of tax relief while increasing your retirement benefits.

If you fit the profile I've described, I recommend serious consideration of an IPP. In the past, individually tailored pension plans were prohibitively expensive. But, today, you will pay only about \$500 a year to reap the benefits of your own retirement pension plan.

You'll read more about this

IF YOU ARE A BUSINESS OWNER, OR PROFESSIONAL, AN INDIVIDUAL PENSION PLAN MAY BE YOUR BEST CHOICE

exciting strategy on the inside pages of this Client Quarterly but here are some of the major advantages of an IPP:

- Higher tax deductible contributions than a RRSP. This means an enhanced retirement income as you are able to put more away on a tax effective basis.
- Past service contribution is significant and also tax deductible. Past service is the amount of extra contributions that could be made to a pension plan as if the pension plan was in effect since 1991.
- Creditor-proof. IPP assets are sheltered from claims by creditors.
- Interest on IPP loans can be deducted as a business expense, which is not possible for an RRSP loan.

The IPP is better than an RRSP in three different ways: higher current service contributions; past service contributions and terminal funding.

These three advantages lead to a bigger and better pension and higher tax deductible contributions. I'll explain more about these benefits on the inside pages of this newsletter.

The IPP has proved to be a strategy that fits for those with good cash flow looking for meaningful tax deductions that don't involve tax risk. Contact me before your corporate year end to see how the IPP can provide tax relief and enhance your own retirement income stream

Also in Client Quarterly this issue, Chartered Accountant Chris Thurgood has contributed an insightful article on the high cost of non-deductible interest and what you can do about it.

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An Individual Pension Plan can help self-employed business owners and professionals plan and contribute toward a guaranteed pension income after retirement

HIGHER TAX DEDUCTIBLE CONTRIBUTION LIMITS THAN RRSPS MAKE IPPS VERY ATTRACTIVE

QUESTION: What exactly is an Individual Pension Plan?

ANSWER: An IPP is a maximum defined benefit plan which provides contribution amounts in excess of RRSP contribution limits for people who satisfy certain age and earnings criteria. Essentially, it's a pension plan similar to those available to people who are not self-employed but work for a company owned by someone else.

QUESTION: What do you mean by a maximum defined benefit plan?

ANSWER: An IPP will pay you a "defined benefit" upon retirement. Your plan is designed so that you will receive a pre-determined maximum allowable pension. As you can see from the chart on this page, those who qualify for an IPP can contribute a significant amount more towards a retirement fund than those who contribute to an RRSP. That's why an IPP has been called a "super" RRSP.

QUESTION: Who is the ideal candidate for an IPP?

ANSWER: A business owner, professional or executive who wants long term retirement planning, is over age 40, earns at least \$100,000 per year, and who will need to contribute to more than just an RRSP to make the retirement plan work. If that profile fits you, the question you should then ask yourself is: "If RRSP limits were significantly higher than they are now, would I take advantage of that higher contribution limit?" If your answer, is "yes," than an IPP is probably very much worth considering.

If RRSP limits were significantly higher than they are now, would I take advantage of that higher contribution limit?

QUESTION: Is an IPP a new concept?

ANSWER: No, as the IPP is a one-person, defined benefit pension plan, an actuary's help is required to both implement and administer the plan. However, these plans are much more affordable today than they were in the past. A few years ago, the cost was several thousand dollars to set up and manage an IPP. Today, an IPP will cost most people approximately \$500 per year in management and administration fees.

QUESTION: Are there tax advantages to an IPP?

ANSWER: Definitely. These increased contributions translate into more expenses that are tax deductible. Small business owners can use an IPP to reduce their active business corporate income and take advantage of the small business deduction in order to reduce taxes. The small business active business corporate income threshold limit in 2007 is \$400,000 in BC. An individual's corporation can even borrow for an IPP and deduct the interest as a business expense, which is something that very definitely cannot be done for an RRSP loan.

THE IPP ADVANTAGE CONTRIBUTION MAXIMUMS FOR 2007

AGE	IPP MAXIMUM CONTRIBUTION	RRSP MAXIMUM CONTRIBUTION	IPP ADVANTAGE	ADDITIONAL YEAR 1 MAXIMUM PAST SERVICE CONTRIBUTION
45	\$22,720	\$19,000	\$3,720	\$69,608
50	\$24,957	\$19,000	\$5,957	\$104,136
55	\$27,414	\$19,000	\$8,414	\$142,056
60	\$30,113	\$19,000	\$11,113	\$183,704
65	\$33,469	\$19,000	\$14,469	\$235,496

CLIENT STORIES

Brian

Over the last 25 years, Brian's product distribution business has grown dramatically. After a modest start in a basement office in his own home, with himself as the only employee, Brian now employs a sales force of more than 15 people.

Brian is now in his 50s and, while his business continues to grow year after year, he now thinks more frequently about retiring. So, although he has still not made up his mind to sell his business, maximizing his tax effective retirement funding has become an immediate priority for him.

Brian wanted to contribute more than just the RRSP maximum available to him. The past service contribution made sense as it helped to bring his active corporate income down to qualify for the small business deduction.

Brian is still wondering what his life might be like when he finally retires. But while he may not yet be ready to make up his mind about whether to sell his business, saving money and taxes with an IPP was a "slam dunk."

David & Jenny

Over the years, David and Jenny built an engineering and manufacturing business together and, despite some very challenging years, are today very successful. Not only have they been able to pay down the mortgage on their corporate offices and plant facilities, they have also expanded their premises while continuing to enjoy an excellent cash flow.

Now both in their 50s, David and Jenny have each drawn a high income from the company and have contributed for many years to an IPP. These contributions, which have increased every year — plus their past service contributions — have also helped to reduce their corporate income and taxes.

Knowing their IPP contributions have maximized their retirement income investment, David and Jenny are comfortable about the prospect of their future life together. And they enjoy additional peace of mind with the knowledge that their IPPs are protected from creditors.

These are true stories about clients of Malinka Financial. However, client names and some of the details of their stories have been changed to protect their confidentiality.

ADVANTAGES

- Higher contribution than RRSP (see Table for the IPP advantage). Higher contributions mean an enhanced retirement income as you are able to put more away on a tax effective basis.
- Past service contributions can be quite significant when a plan is set up and are deductible as well.
- Terminal funding provides the opportunity for possible enhancements to reduce or eliminate a smaller pension income due to early retirement. This funding is also tax deductible.
- IPP's are creditor proof as the assets are sheltered from claims by creditors.
- An individual's corporation can even borrow for an IPP and deduct the interest as a business expense, which is something that can't be done for an RRSP loan.
- Ability to make further tax deductible contributions if the plan investments haven't done well and it is in a deficit funding position.

DISADVANTAGES

- No access to funds while the employed member is a member of the plan.
- The funds are locked in until retirement and there are some restrictions on the types of retirement income plans the IPP can be used to fund as the benefits are locked in.
- As the IPP is a one-person, defined benefit pension plan, an actuary's help is required to both implement and administer the plan. These fees have dropped considerably over years gone by, making the IPP even more attractive.

PLAN INVESTMENTS

- Plan assets can be invested in an pension eligible investment, such pooled funds, T-bills, bonds, GIC's, etc. An IPP has the same investment flexibility as a self-directed RRSP.

BENEFIT OPTIONS

- An immediate or deferred pension paid from the pension plan.
- An annuity purchased from an insurance company, or
- A lump sum, commuted value of accrued pension benefits, part or all of the amount can be transferred to an RRSP/locked in RRSP or RIF/LIF.