David Chong Yean & Eugene Chu - Caring for your Money - Year-End Tax Considerations

Chiraz: Hello and welcome to CDA Oasis, my name is Chiraz Guessaier. I am pleased to welcome David Chong Yen and Eugene Chu once again to CDA Oasis. David and Eugene are professional chartered accountants who have been working with dentists for quite a while. As the new year approaches, they kindly suggested that we speak to dentists about what matters most to them, namely their money. David and Eugene, it's a pleasure to see you again and host you on a Oasis. Thank you for sharing your knowledge and time with our audience.

David C. Yen: It's a privilege and it's a pleasure. Thank you for having us.

Chiraz: You're very welcome. Always. So, the year end is fast approaching. What should dentists do?

Eugene Chu: Well, the first thing you want to do is before year end you want to see if there's any kind of expenses that you're going to have to incur anyways and try to get/sneak those in before the year ends. So if you need to renovate your office, upgraded equipment, buy computers etc., you want to do that so that you can get the tax break before your year end occurs instead of afterwards. So speeding up your expenses just before year end is one tip.

Eugene Chu: Conversely, if you have any large cases you want to delay the income to the following year. So, if you have to place implants or do some crown and bridge work, you might want to schedule those patients till after your year end, where it can wait so that way you delay the income for an entire year and delay the taxes.

David C. Yen: And give them this time of the year a lot of office parties are occurring. Eugene mention to them about the meals and entertainment and how most times meals and entertainment are only 50 percent tax deductible. But there are some exceptions to that rule and given this time of the year when many dentists are taking the entire office out for a party. It's very appropriate and timely.

Eugene Chu: So, most people do know the rule that 50% of your meals and entertainment are tax deductible. What they don't usually remember is that of those meals, six of them, as long as you invite all your staff to that party, that's 100% tax deductible. It's not 50%. So, you can deduct the entire amount. Works well for, like Dave said, office parties during the holidays and then the other celebrations that are happening at the practice.

David C. Yen: That's a nice segue way too Eugene. You mention holidays. So, many of our dental clients take vacations, especially during this time of the year, and we say to them have you considered taking a vacation, tacking it on either at the front

end or at the back end to your CE courses? So, some of them may be going on a continuing education course and then they tack on the vacation at the front end, the fight to and from will be fully tax deductible. And of course, if they are taking the continuing education course sometimes there are cruises. Some of these cruises they provide these continuing education courses. So you really get two things for the price of one,

Eugene Chu: If you're going to be giving bonuses to your staff, you might want to consider instead of a cash bonus to give a gift or award that's a non-cash item. So, the benefit being that you don't have to pay the CPP, the EI or the payroll taxes and the staff, they'd received that gift tax free. So, it's up to $500 per year.

David C. Yen: Last year the government implemented so stringent tax changes limiting tax savings i.e., limiting income splitting, i.e., paying/using family members in the tax savings game. So, previously a dentist could pay his spouse or her spouse, parents, children's dividends if there were 18 and older, Canadian residents, and sometimes children for example we're going to university could get $50,000 in dividends, pay virtually no taxes and not work in the dental practice. That's been a major change, i.e. the government has placed constraints on that, i.e., you need to be working 20 or more hours per week throughout the year on behalf of the practice. However, there are still ways to save taxes by sprinkling income among different family members. Eugene, why don't you elaborate?

Eugene Chu: So, what you could consider is hiring your family members as employees and giving them a reasonable salary. You can also give them a reasonable bonus as well for any work that they've done for the office and that bonus can be paid within six months of year end, so it doesn't have to be paid right away, but it can be paid six months after year end and still deducted as an expense before year end. You also want to consider, for your children, there's different ways to save taxes. So, you can consider investing in an RESP for your children, if you haven't done so before the end of the year, that way that income when they do go to university will get taxed in their name, not your. So, you're effectively splitting that income.

David C. Yen: There are also some practical ways of saving taxes by sprinkling income among family members. One of them is where let's say the richer family member lends money to the poorer or family member. Elaborate for me there Eugene.

Eugene Chu: So what you want to do is you can have a loan and so the loan has to charge an interest rate, currently of two percent, and so the higher income spouse loans money to the lower income spouse or lower income family member, the lower income family member invests that money and whatever investment return they earn, that gets taxed in the lower income family member's name basically. The only requirement is that the lower income family member has to pay that two percent interest and they have to be done every year before January 30th.

David C. Yen: Simple, effective, is for the richer spouse to pay for all personal expenses. Example, the richest spouse would pay for clothing, food, entertainment, children's tuition, vacations, etc. And then the poorer spouse would invest. This way all the investment income would be taxed in the poorer spouse's hands. Now be careful to. Along that theme we should have separate bank accounts, i.e., the richest spouse should have his or her own bank account, the poorest spouse having a separate bank account so that we don't co-mingle or mix the moneys. Why? In the unlikely event of an audit, we can trace where the monies came from and where it went, i.e., we can trace the source of the investments and therefore the investment income we can justify being taxed in the poorer person's hands. Another item, much bigger ticket item, is multiplying the lifetime capital gains exemption which is about $850,000 and equates to about $230,000 in actual tax savings. How would you go about multiplying those lifetime capital gains exemption Eugene, and would apply to, let's say a child is one year old?

David C. Yen: So, the government had announced potentially removing that, but they've decided not to. So that is still on the table. So, anyone, they don't have to be 18 years or older, can become an equity shareholder of a professional corporation or a hygiene or technical service corporation. So that means they're not allowed to get dividends, but they can, when you sell the practice, they're able to get their share of the practice proceeds from the sale price that you get. So if you sell your practice for $2,000,000 and you have three shareholders, everyone would get/split $666,000 and that income would be taxed in each family member's name and they would use their capital gain exemption, which is $850,000 and they would pay virtually no tax. And so, the family would take the entire $2 million from that sales proceeds into their bank accounts.

David C. Yen: On a practical note as well, virtually any Canadian resident can receive how much income and pay virtually no taxes Ge?

Eugene Chu: So about $12,000 in salaries one can receive and basically pay no tax.

David C. Yen: So that provides a tax savings opportunity. Let us give you an example. Let's say you paid an 18-year-old child to look after your 16 year old child. You paid them, let's say $5,000 to babysit the 16-year-old child. Explain to them how you could save taxes with that example, Eugene.

Eugene Chu: So childcare expenses are tax deductible. The person claiming it would have to have a salary and so they're reporting the salary income and they get a tax deduction for the childcare expense and since the 18-year-old, assuming they have no other income and the first 12,000 is tax free, that $5,000 basically there's no tax on it. So, the family just gets a tax deduction with no income that's reported, produces no actual tax bill for that child.

David C. Yen: And the reverse could apply, i.e., let's say you have a child, you could pay your mom or dad, your in-law to babysit and your mom or dad, if they're not making much money, would report the income you paid them. But again, the first $12,000 is tax free. So that's another opportunity. Due to the liberal tax changes there have been higher tax rates on certain types of income, passive income. So passive income means you put your foot up, you sit back, and you collect money, you collect income. That's considered passive income. So perfect example would be if you invest in a term deposit or a GIC, you don't sweat, and you generate interest income. That's considered cost of income. The tax changes affect passive income and explain to them how it affects it and how we can get around it Eugene.

Eugene Chu: So, the new tax rules basically are saying that if your corporation generates $50,000 or more of passive investment income, then the corporation is going to start facing a higher tax rate on its normal dental profits will no longer be taxed at, in 2019 would be 12.5 per cent. It could be taxed at 26 per cent. So you want to avoid that bump up in the corporate tax rate by managing your passive investment income. So, one way to do it is you can take your excess cash and instead of investing in GICs, stocks, etc., invest it in active assets. So things that don't create passive investment income. So that could be another dental practice, that could be the dental building you work in. It could be dental charts from a nearby clinic. Um, other things that don't produce passive investment income.

David C. Yen: You could buy dental equipment, upgrade your office, complied with the infectious disease control regulations, thereby using up your surplus cash, sucking out some of your investments, and then putting it towards those expenditures. And so, what you're doing is reducing the amount of passive income and increasing your active dental income. Because believe it or not, the tax department views the purchase of your dental building that you use solely for your dental practice in a similar light as equipment, i.e., it's a necessary tool. They don't view it as a building. So, you get good tax breaks when you buy your own building, but in addition to that, we had previously discussed this on another Oasis discussion video, that by buying your own building, you are in essence protecting your dental practice investment. Why? Because if you're your own landlord, you don't have to worry about the landlord inserting a demolition clause, which means that they could demolish the building at any time an erect a condominium or you don't have to be concerned about your relocation clause whereby they can relocate you from one part of the plaza to another part of the plaza. So, bottom line, buy your own building it's good for taxes as well as it protects your dental investment.

Eugene Chu: What you can consider is investing in investments that don't necessarily pay a dividend or pay a very little dividend so that way you can keep it under the

$50,000 threshold so these stocks would more likely just appreciate invalue and you get a capital gain instead when you ultimately sell.

David C. Yen: Right. So basically, buying investments that rise in value and pay out no dividends. Another option is for your members to consider having their professional corporation (PC) use some of the surplus cash and invest in an individual pension plan (IPP). What's the benefits? The benefits are the PC pays for and gets a tax deduction for contributing to your pension plan. Secondly, the contribution limits, if you're typically more than 40 years old, are significantly more than an RRSP. So higher limits, plus you're paying for those contributions with cheap PC tax dollars, plus the PC gets a tax deduction for the contribution to your pension plan. In addition, the monies that go into the IPP (individual pension plan) is credit approved. Credit approved means it's protected from lawsuits, protected from creditors. So that's one thing to consider. The downside of that suggestion, the downside of the IPP, the disadvantage, is that there's some costs to set it up and to maintain it.

David C. Yen: Another option as well is, again, we don't sell insurance, so is to use some of your surplus funds inside your company to buy, for example, a whole life policy or perhaps a universal life policy. These are insurance policies which are really comprised of two components. One is a death benefit, amount payable upon your death, and the second is an investment component. The bottom line is when you use surplus funds of the PC, for example, to invest in say a universal or whole life policy, the money grows tax free. However, there's a caveat and I'm going to show you the other side because oftentimes when people sell these policies, they don't tell you the disadvantages.

Eugene Chu: When you want to claim the capital gain exemption, there's two main tests that you have to pass, and the primary goal of those tests is that you can't have any passive investment income inside your corporation at the time of sale. A UNLV policy or a whole life policy is considered inactive or a passive investment, so that makes it much harder to qualify for the capital gain exemption and so upon sale you would have to get rid of the life insurance policy that the PC holds because otherwise we won't be able to sell the PC shares and claim the capital gain exemption. So, in doing so, it could trigger significant taxes to get rid of that UNLV policy into another company or into your personal name.

David C. Yen: Another option perhaps is to have a holding company. Buy, own and pay for those premiums, those life insurance premiums. So that's another option. But I just wanted to paint to your members ways of avoiding this onerous tax change and how to prosper using alternatives.

Chiraz: David and Eugene, I cannot thank you enough. These are very valuable tips and thank you again for sharing your knowledge and your expertise. Only you can do it for us. We really appreciate it.

David C. Yen: It's a privilege and it's a pleasure. Thank you very much.