Five creative ways to ‘disguise’ income and save tax

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Last updated Wednesday, Feb. 06, 2013 07:45PM EST

My son came to me this week with his latest toy that he received for his birthday. It was a Transformer. You know, one of those robot creatures that can turn into all kinds of things – if you can figure out how to bend it in the right directions.

“Dad, can you turn my Transformer back into a police car?” he asked. Now, the last thing a father wants to feel is inadequate in front of his son when it comes to mechanical things, and I consider myself pretty good with power tools and the like. Evidently, not good enough. I couldn’t turn that thing into a police car if my life depended on it. So, my son had to settle for a hockey player on horseback.

Instead of transforming a robot into a police car, I find it a lot easier to transform one type of income that will be taxed at a higher rate into another that will be taxed at a lower rate. This is what I refer to as “disguising” income, and it’s the fourth pillar of tax planning. Here are five creative ways to disguise income – and save tax.

1. Consider a corporation to hold investments. By holding some or all of your non-registered investments inside a corporation you’ll remove any income on those investments from your personal tax return (“disguising” personal income as corporate income). This could reduce a clawback of government benefits such as Old Age Security. It can also minimize U.S. estate tax on U.S. securities and minimize probate fees. In some provinces (Ontario, for example), the tax you’ll face on investment income inside the corporation is currently less than what you’d pay personally if you’re in the highest tax bracket.

2. Set up a back-to-back prescribed annuity. This idea can provide greater after-tax cash flow than straight interest income. Here’s how: In place of interest-bearing investments, consider taking all or some of that capital and buying a prescribed annuity. A portion of each annuity payment will be taxable interest, but a portion will be a tax-free return of capital. You’ll face less tax and put more in your pocket. This effectively “disguises” interest as tax-free returns of capital. The drawback? Your capital will be paid back to you over time so there will likely be nothing left to leave to your heirs upon death. You can solve this by taking some of the additional cash flow from the annuity to purchase a life insurance policy (back-to-back with the annuity) that will pay out on your death, replacing all of some of that capital.

3. Argue that it’s a business. If you’re doing something over and over you might take the position that it’s a business. This may allow you to argue that a certain type of income – highly taxed interest, for example – is actually business income, eligible for deductions to be claimed. A friend of mine lends money quite often. Last year he had seven loans outstanding and earned several thousand dollars in interest. He has always taken the position that his income is business income since he does it frequently and he claims deductions against that interest income, saving tax dollars. He has effectively “disguised” interest as business income by carrying on this activity often.

4. Redeem shares with paid-up capital. If you own shares in a corporation, then you have something called “paid-up capital” (PUC). Your PUC is a cousin to your adjusted cost base (ACB) and simply represents that amount of money you can receive on a tax-free basis from the corporation by redeeming your shares. It’s also possible to extract your PUC without redeeming shares, by simply reducing your stated capital (see a tax pro for more details). Extracting your PUC is a way to “disguise” what might otherwise be taxable dividends as tax-free returns of capital.

5. Consider a mutual fund that controls income (Corporate Class). Some mutual fund families are structured as corporations. Each fund in the family is a different share class in the particular corporation. You can switch between classes (funds) on a tax-free basis, and when it comes to receiving cash distributions, you can even choose the type of income you’d like to receive (capital gains, returns of capital and Canadian dividends are more tax-efficient than interest or foreign income). If you prefer to defer tax by not receiving distributions, this is also an option by choosing the right class (fund). Consider investment merits first, but recognize that tax savings can add up.

The cheapskate's guide to income

Here is a glimpse into what types of income are most tax-efficient.

Type of Income	High Tax	Low Tax	Tax Free
Employment			
Salary and wages	x		
Bonuses	x		
Stock options		x	
Non-taxable benefits			x
Investment			
Interest	x		
Foreign income	x		
Royalties	x		
Net rental income	x		
Canadian dividends		x	
Capital gains		x	
Return of capital			x
Capital dividends			x
Business			
Net self-employment income	x		
Shareholder loans - non-eligible uses	x		
Shareholder loans - eligible uses			x
Other			
Life insurance proceeds			x
Gifts or inheritances			x
Lottery winnings			x