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Corporate Taxes and Supplemental Pension Funding

By Pierre Ghorbanian, B.Comm, CFP, FLMI

There has been much debate, misunderstanding, and misinformation regarding the General Rate Income Pool (GRIP) for earnings above the Small Business Limit (SBL). When the GRIP was introduced, there was a flurry of articles promoting the use of the GRIP rather than continuing with the normal practice of Bonusing down to the SBL. But as theory faced practice, a series of articles started to be published that play down the benefits of the GRIP and retained earnings strategies over the SBL.

Required Background Reading

Some articles that must be read to understand the real effects of the GRIP and Corporate Taxes relative to supplemental pension funding include:

Advisor Edge Report, 'Getting the GRIP on CCPC Dividends', April 2008, by Carl Rosen, BA, B.Litt, LL.B, JD

CCH Estate Planner, 'Eligible Dividends - A Prediction', May 2008, David Louis, CA.

CLU Comment, 'RCA, Dead or Alive', Sept/Oct 2008 #251, James Kraft, CA, M.Tax, CFP, CLU & Debbie Kraft, M.Tax, CFP, CLU, TEP

Getting a GRIP on Corporate Tax Rates

As corporate tax rates decrease to 2012, the Eligible Dividend Tax Rates continue to increase. Some might say smoke and mirrors? Mr. Louis' article explains why Canadian Controlled Private Corporations (CCPCs) with earnings above the small business limit will not establish a GRIP to receive Eligible Dividends. The difference between Eligible and Ineligible Dividends will be a tiny 0.29% federally by 2012. As such, the GRIP will not be the reason why one would change corporate accounting practices.

The real advantage of lower corporate tax rates is relative to funds reinvested in the Corporation, not set aside for distribution to the Owner/ Shareholder.

The Analysis

In the Kraft's article, the table labeled "Analysis of Alternatives" shows a numerical comparison of Bonus Out, Dividend Out, and a Retirement Compensation Arrangement (RCA). The figures were based on a $100,000 pre-tax contribution funded over 10 years with a rate of return of 5%.

	High Tax Province		**Low Tax Province**	
	Accum. Values Taken from CLU Article	**After Tax Value**	**Accum. Values Taken from CLU Article**	**After Tax Value**
Personal Accum-ulation	$597,170	$597,170	$722,287	$722,287
Corp. Accum-ulation	$790,283	$608,043* or $578,961**	$877,924	$724,287****
RCA Accum-ulation	$1,148,347	$615,399***	$1,148,347	$700,492*****

Assumptions:

* 2009 Eligible Dividend Tax Rate at 23.06% (Ontario)

** 2012 Proposed Eligible Dividend Tax Rate at 26.74% (Ontario)

*** Ordinary Income Tax Rate @ 46.41% (Ontario)

**** Eligible Dividend Tax Rate @ 17.5% MTR (Alberta)

***** Ordinary Income Tax Rate 39% (Alberta)

Looking at a high tax province like Ontario, the after-tax benefit is approximately $597,000 for Bonus Out; $608,000 for Dividend Out and, $615,000 for the RCA. In 2012, the Eligible Dividend Tax Rate will either be approximately 26.74% (if the province implements changes in the 2008 Provincial Budget) or 30% otherwise. In either case, that would make the Dividend Out after-tax benefit in this comparison either approximately $578,000 or $553,000.

Of course, the Effective or Average Tax Rate could have you at a lower rate, which would increase the after-tax values, but, in many cases for a high net worth executive, the effective tax rate tends be closer to the marginal tax rate.

Is it fair to say that the Executive from a High Tax Province should setup RCAs, while Low Tax Province should Dividend Out? The answer is no! As the Kraft's mentioned in their article, "**financial planning should not be led by numbers**". It may appear that the RCA provides better retirement benefits largely due to long term tax deferral in a high tax province. This is despite the fact that half of the funds are sitting in the Refundable Tax Account (RTA) which is effectively treated as a cash account that does not earn any interest. It also may appear that the RCA does not provide a larger after tax benefit than Dividend out in a low tax province like Alberta. However, there are still other quantitative and qualitative factors and benefits to consider to determine if the RCA is a good strategy or not for the Executive. As well, it is possible that over time, the RTA transfer will be re-aligned to current corporate taxation rates.

Benefit Considerations

Creditor Protection is one which is paramount to a Business Owner. Monies held in a corporation can be vulnerable to corporate creditors, and even a Holding Company wouldn't have protection from certain creditors.

The "rollover" or generational asset transfer is another key benefit. There is no 21 year rule on the RCA Trust, so unused benefit funding could flow from one generation to another (eg: Parents to Grandchildren) at their own tax rates. All funds are away from the Estate, thus avoiding probate tax and estate fees upon death.

For corporations (irrespective of tax rates), the RCA is valuable in retaining Key Executives, funding SERPs, or funding shortfalls in existing corporate pension plans.

Unlike traditional Registered Pension Plans, RCAs have no minimum or maximum withdrawal or age requirements; allowing for the executive to control the timing and income recognition from the RCA Trust. This could be even more valuable if marginal tax rates decrease or if the executive retires in a lower tax jurisdiction.

Corporate Insurance Solution?

There are some in the insurance industry that are saying that its better to have maximum funded tax-exempt Corporate Owned Life Insurance (COLI) using retained earnings, and subsequently then paying dividends to the shareholder at retirement supported by loans on cash in the policy. What most commentators tend to ignore is the Deemed RCA provision in Subsection 207.6(2) of the *Income Tax Act* (ITA), or as described on Page 5 of the CRA's 2008 RCA Guide:

"**An employer or former employer may acquire an interest in a life insurance policy (including an annuity) to fund benefits on, after, or in view of an employee's retirement, an employee's loss of an office or employment, or any substantial change in the services the employee provides. In this case, we consider this interest to be the property of an RCA and the employer to be the custodian of the RCA**"

(Source: http://www.cra-arc.gc.ca/E/pub/tg/t4041/t4041-08e.pdf)

What is important is employee status, real and underlying intent of the contract. The Deemed RCA rules most certainly apply if the policy is owned by the Operating Company (OpCo) and the insured is an employee of the OpCo. Having the policy owned by a Holding Company (HoldCo) could still run the risk of Deemed RCA rules. If the "employee" of the OpCo is also the owner of the HoldCo that owns the shares of OpCo, it is a stretch to say that 207.6(2) could not be applied to the HoldCo.

The Loan Inefficiency of COLI

The bigger question is; how does one efficiently get the funds from a Corporate Owned Life Insurance (COLI) policy? Using the insurance policy as collateral to get money out via Dividends will not provide a larger after tax income because the maximum amount that can be borrowed today on the collateral of the insurance policy is in the range of 50% to 80%. To secure something closer to 80%, usually all underlying assets are moved to low yielding fixed income investments. More importantly, with all the credit problems right now, why would any Executive/Shareholder want to secure a loan at retirement to provide him/her a stream of retirement income?

Should the loans ever exceed the loan ratio, the margin call may result in the Lender demanding partial repayment or demanding additional contributions into the policy to bring the loan ratio down, or surrendering the policy. It's certainly something that is not very attractive for a Business Owner/Shareholder when he or she has long since retired.

A Pension Solution to a Pension Problem

If you determine that a Business Owner or a Key Executive has a pension shortfall problem due to funding limits in RRSPs, then it is important that a Retirement Compensation Arrangement (RCA) and/or Individual Pension Plan (IPP) be implemented and funded to the maximum allowed under CRA guidelines. Post RCA, a Corporate Owned Life Insurance policy can be used to enhance dividends without the same concerns over the Deemed RCA rules.

Accountant's -The Gatekeeper

In the end, it is primarily the corporation's Accountant that will decide whether to Bonus Out, Dividend Out, or establish an RCA and/or IPP. Here in Ontario, you will find most Accountants' will continue to Bonus Out over Dividend Out if the funds are for Shareholders use. If required by the Corporation, they are less likely to Bonus Out, and then have the Executive/ Shareholder lend money back to the corporation for working capital. What the lower corporate tax rate and GRIP rules will do is make the Retained Earning Strategy more and more common if the CCPC needs the cash. But if the CCPC and the Executive/Shareholder do not need the cash, the RCA and/or IPP will still be the preferred option.

As always, each clients circumstances must be examined on a case by case basis. Many CCPCs with earnings above the Small Business Limit will typically have earnings between $500,000 and $1,500,000. As such, the Bonus Out or RCA/IPP would be the option most Accountant's will recommend to go with to avoid Ontario's 4.25% provincial surtax for earnings above the Small Business Limit.

Of course, if the CCPC is below the Small Business Limit, then an IPP in conjunction with a Dividend Out strategy could be the preferred strategy over an RCA from a tax perspective, but not necessary a good long term strategy if you factor in all the other estate planning benefits of the RCA.

One would have to look at the specifics of the case to determine the best strategy.

Conclusions

Financial Planners and Advisors must look at all factors, and not focus on the theoretical tax rates that may or may not materialize 10 or 20 years from now to properly advise clients.

Making retirement decisions based on theoretical tax rates often does not provide the desired results. Sound financial planning requires you to look at all aspects, and not just one component.

What is important to understand is that RCAs, IPPs, and COLIs are not competing strategies. Those who say that a maximum funded COLI addresses all problems may not be looking at all the facts from a prudent financial planning point of view.

Pierre Ghorbanian, Managing Partner
Retirement Compensation Funding Inc

About the Author

Pierre Ghorbanian is the Managing Partner of RCF. Case consulting with Advisors, Accountants, and Clients are his primary responsibilities. Pierre holds a Bachelor of Commerce (Hons.) degree from the University of Guelph, and he also holds the Certified Financial Planner (CFP®) designation from the Financial Planners Standard Council.

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416.364.6444 | info@rcf.ca | www.rcf.ca

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