RcF News

Business Owners—Pensions & Planning

By Roy W. Craik

Introduction

Pensions are a very important component of any financial or tax planning strategy. RRSPs, MPPPs, RPPs and IPPs are part of the solution but they are not sufficient for those earning above $150,000. Business owners are entitled to a pension of 2% per year of service based on a final average annual compensation.

Retirement Compensation Funding (RcF) has been the Supplemental Pension thought leader in Canada since 1987 and it is our view that business owners need to treat their retirement "Living Money" in a manner that fully protects them and their family. With "Living Money" safe, there is not the same concern if aggressive tax planning or investment strategies for "Play Money" do not meet expectations, or fail.

To fund pension entitlements for earnings impacted by regulatory "caps" (usually above $150,000), CRA allows a company to establish a Retirement Compensation Arrangement (RCA) defined under section 248 (1) of the Income Tax Act. Like RRSPs, contributions to the RCA are tax deductible to company and not taxable in beneficiary hands until withdrawn in retirement. Unlike RRSPs, there is no contribution cap. RCAs are funded to provide projected pension shortfall entitlement. Unused RCA contributions are also carried forward like an RRSP.

If a Business Owner has a pension shortfall, this benefit and tax deduction (which with past service included, could be substantial) should not be ignored. RCAs can be funded on a "Conventional" and/or "Insured Tax Sheltered" basis. There are many advantages to an "Insured Tax Sheltered" RCA but expertise is required to ensure proper implementation.

Experience

For 25 years RcF has helped many Canadian business owners resolve planning issues and achieve overall financial and estate planning goals. Whether you are the sole owner of the corporation or there are multiple owners, RcF can structure a plan to encompass Retirement Security and many other possible financial planning needs as described in this article.

Retirement Security

Leaving assets in a corporation for a long period of time (that are not needed for corporate growth) for theoretical tax savings that could be used to provide a client with additional retirement "Living Money", is a dangerous road to follow. Tax savings must also be weighed against other corporate risks (litigation, business downturn, tax audit, etc.). Sadly, many companies flame out as an owner reaches retirement or, there is no buyer at desired price.

Aggressive investment and tax planning strategies should not apply to retirement assets. Financial Planners should be responsible and encourage clients to set aside "Living Money". There is still lot's left over to "Play" with. Diversification is key in any financial plan.

Spousal Benefits

Often overlooked, spousal benefits in retirement planning are as important as replacing working income in insurance planning. The latter can be inexpensively dealt with using term insurance.

With an RRSP, if death is prior to normal retirement, a survivor is penalized with reduced benefits. Even post retirement, bad investments can impair survivor benefits.

Unlike RRSPs or other registered pensions, RCAs can have a mortality component attached to investments providing the cost does not exceed that of a “conventional” funded RCA.

Dependant on insurability, a properly designed “Insured Tax Sheltered” funded RCA survivors can receive: (i) age 65 benefits if plan member dies prior to retirement (ii) unreduced indexed benefits at same cost as conventional funding.

Investments

Many RRSP or DC / MPPP investors have taken a hit on their investments over the past 12 years. Under current legislation, you are not allowed to make extra contributions into the plan to recover the losses. However, those losses can be made up by having the Company make contributions into an RCA allowing for pension loss recovery not available in other plans.

Unlike traditional retirement 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 rates decrease or if the owner retires in a lower tax jurisdiction.

Creditor Proofing

Is it wise to keep an owners retirement investments in a corporation notwithstanding potential tax savings? Business Planning vs Tax Planning.

Preparing for the unthinkable is part of Business Planning. Even good companies experience bad luck over the years. The unthinkable could include environmental, accidental, negligence, creditor, business losses, tax liabilities, etc. In most cases, alternative strategies do not fully protect the business owner. Corporate owned life insurance, investments and Holdcos are all subject to some risk.

Corporate owned investments including life insurance are vulnerable to creditors. Professionals such as doctors and lawyers cannot setup a Holding Company to hold the shares of the corporation and the E & O protects personally but not the Corporation.

Even though Holding Company investments are generally protected from liabilities of the Operating Company, they could still be vulnerable to creditors such as lenders by way of shareholder actions.

An RCA compliments other retained earnings strategies spreading risk. It is common sense not to have all of ones eggs in the same basket.

Estate Planning

Estate Planning is an ongoing process and adjustments must be made from time to time or when significant changes arise. Luckily, the planning relative to the RCA can be adjusted as circumstances change to meet the business owners’ estate planning needs.

An RCA is a Trust independent from your estate and both corporate and personal assets. Information including beneficiaries can remain private unlike your estate, which becomes public domain upon probate.

The RCA Trust is also not subject to the 21 year rule avoiding the deemed disposition of assets. Sometimes the plan member & survivor do not spend all of the supplemental retirement income to which they are entitled.

What's left can provide an income to named beneficiaries.

The ability to name beneficiaries can also help with **Family Equalization** allowing a business owner to keep an even hand with all children. If one child is involved in the business with their own RCA and a second child that is not involved, they could be the beneficiary of the owners RCA. With mortality gains and other assets, the owners RCA often can provide equivalent benefits to the sibling in the business.

Estate Freezes can also be problematic if the company experiences stronger than expected growth. Oftentimes parents find themselves frozen out of earnings growth in excess of the preferred shares issued resulting from the freeze. The purpose of an Estate Freeze is to reduce the impact of death taxes. Children should not disproportionally benefit from increased earnings over parents/ founders.

An RCA compliments an Estate Freeze and, can remedy concerns of an existing Estate Freeze. Assuming there is an unfunded pension liability, the corporation can make a contribution (from pre-tax earnings) to the RCA Trust for the benefit of parents/owners. Excess retained earnings that otherwise would benefit children, now enhance the retirement of the parents with the Estate Freeze intact.

Business Succession Planning

Often times, the sale of a business is compromised by the after tax cost of the purchase and/or the ability to finance. There are limits to what can be borrowed and, banks sometimes prefer to have a direct charge on business assets rather than an indirect charge through new owners.

RCAs can receive both Terminal and post-retirement contributions to fund benefit liability. Contributions can reduce the value of a company for new owners. What is lost if a key-employee with years of expensive training and experience walks out the door? What value is lost to shareholders?

If the owner plans to use some of the sale proceeds to supplement retirement income, an RCA can be a key component of a sale.

In a simple example, let us assume the owner and buyer are separated in agreement by $1m on price and, a properly pre-established RCA (care must be taken for RCAs established at time of sale less they be deemed a Salary Deferral Arrangement) requires a Terminal Funding contribution of $1.5m. Let us also assume that the owner has utilized the $750k Lifetime Capital Gains Tax Exemption (LCGE) and both owner and buyer are subject to a maximum tax rate of 50%. Here is what happens:

- If the owner receives the additional sale price of $1m, the net to the owner is $750k
- If the buyer borrows that $1m from the Bank, that equates to pre-tax income of $2m to repay principal
- The RCA requires a pre-tax contribution of $1.5m with the owner netting $750k on withdrawals.
- $500k of pre-tax income is saved to provide owner with the same $750k net.

If financed, the after tax cost of the Terminal Funding contribution to the corporation is higher at $1.125m but, there are less pre-tax dollars required for re-payment than from a bonus-out. As well, a bank will likely be happier with part of the liability to the corporation rather than all to a buyer personally.

Business Succession Planning should be thought through in advance. Utilizing pre-tax operating income is far more efficient than re-paying bank loans with after-tax income.

A Seller pays no tax on contributions to an RCA until funds are withdrawn in retirement. This offers long term tax deferral.

The RCA can be effective in conjunction with a cash purchase of your shares LCGE Limit has not been used. The buyer can secure the cash or loan up to the LCGE Limit with the rest funded through an RCA to entitlement limits.

In large partnerships (engineers etc) RCAs effectively reduce retained earnings on hand which can be beneficial in buy-out arrangements.

The RCA is an effective tool that can adapt to various situations helping both the Seller and the Buyer achieve efficiencies.

Key Employees

Key employees are hard to find and vital to any business success. RcF has worked with many Private Companies in Canada structuring Supplemental Pensions for key employees.

Offer Key Employees a Supplemental Pension as a reward for their service. It does not have to be 2% per year of service. Plans can be designed with Funding Mitigation or Cost Recovery that will provide these employees with a guaranteed retirement benefit. Retirement security and tax deferral are key components to any key employee package.

The loss of key executives could be detrimental to a company's Succession Planning. They can be motivated to stay and become part of the future by offering them a Supplemental Pension.

Possibly your child / children will assume control of the company but are not quite ready to run the without the help of long standing key employees. You need to ensure that these key employees are retained but want all of the shares to go to your children. By offering key employees a Supplemental Pension with vesting, you are able to provide the company with the support it needs to continue to be a success for your children.

Alternate Strategies

This article is not intended to suggest that other strategies are inferior to an RCA but, to show how an RCA can compliment other strategies within a complete financial plan. It is important to understand that RCAs, IPPs and Corporate Owned Life Insurance strategies are not competing strategies. What can be contributed to an RCA only accounts for part of total pre-tax earnings and/or profits. Other alternative strategies can deal with the excess. Each has pros/cons.

Nor are we competing with bonus and dividend payouts. We are dividing income into two pots. The "Living" fully secured pot and the "Play" pot.

What we do want is Business Owners to understand that an RCA can offer many solutions and can work with existing strategies to provide security and flexibility to their financial plan.

An RCA properly structured can do much more than alternatives to achieve specific goals all within CRA Guidelines.

Corporate Owned Life Insurance (COLI) strategies have their place in the financial plan for business owners. However how does one efficiently get funds from a COLI policy? Using the policy as collateral and paying out dividends will not provide a larger after tax value. The maximum that can be borrowed today on the collateral of the policy is in the range of 50% to 80%. To get 80% policy assets are moved to low yielding fixed income. The loan amount and rates also depend on the financial strength of the client. There is risk of rising interest rates and marginal calls. Is this ideal for your retirement "Living Money"?

When comparing the RCA to dividends or bonus it is important to compare benefits as well as numbers. The RCA is a tax deferred vehicle that offers efficient intergenerational .

wealth transfer of unused funds and/or if reduced life expectancies with, no probate or estate fees. Normally, an RCA does not represent all of an owners money, The key is to diversify your assets and not keep all eggs in one basket.

Conclusion

An RCA is one of the few CRA approved long term tax deferral strategies addressing pension shortfalls and, discrimination (due to the legislative funding caps and limits on your RRSP or other registered plans).

With that said, it is so much more. It can provide retention benefits today and creditor protection long before retirement. An RCA is a critical component to any estate or financial plan for a high earning Business Owner.

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