RCF | Retirement Compensation Funding

Passive Investment Income Concerns

a

Tax Advantaged Retirement Solution

as alternative to

Pre-Retirement Dividend Payments

In 2017, Canada's Finance Minister stated:

"Right now, passive investment income, income that isn't actively being invested back into the company, can be left to accumulate while taking advantage of the lower corporate income-tax rate. Such an advantage is unattended and unfair"

What every business owner must understand

The Budget changes impacting Passive Investment Income may seem unimportant to some now but, could significantly impact funds being set aside in the company over the long term for retirement. Accrued unrealized gains could be the next target and, to eliminate the investment advantage of capital gains.

The Disappearing $500,000 Limit

The extra corporate tax penalty on 5 x every $1 of Adjusted Aggregate Investment Earnings over $50,000 annually has been pitched as only affecting a small percentage of companies. **That appears not true over the long term.**

With current profits of only $150,000, $100,000 of current passive investments (both growing at 5%) and, with the owner re-investing 75% of profits and, setting aside only 25% of profits (for retirement and/or, as a reserve for a rainy day), could see **the small business limit drop to $150,000 by retirement.** Once at zero, the additional corporate tax could be $65,000 (ON) annually.

It is clear that the intent of Budget is to force re-investment back into the company or the pre-retirement payment of personal dividends once the Passive Investment Ceiling has been reached ($1,000,000 at 5% or $1,666,666 at 3%).

Non-Grandfathering Consequences

Many companies already have annual Small Business Profits of $500,000. In fact, they might have profits over this reflected in their General Rate Income Pool or GRIP taxed at the higher rate. As well, they likely already have a Passive Investment portfolio with income un-grandfathered (in this example $750,000).

If gross profits are $800,000 (after owner's compensation), the 1st $500,000 leaves $432,500 (13.5%) after tax and, the next $300,000 leaves $220,500 (26.5%).

Of this total $653,000 in profits (assuming annual and level), $220,500 could be added to investments still leaving $432,500 to be re-invested back in business.

One could argue that since the full $432,500 net after tax on the first $500,000 has been re-invested back in the business, there should be no penalty if the Adjusted Aggregate Investment Income (AAII) exceeds $50,000.

But, that is not the case. The entire AAII will impact tax on the 1st $500,000 even if from passive investments resulting from profits over the small business limit.

Retirement Compensation Arrangements and RRSP*Wraps*

The Income Tax Act allows a **Retirement Compensation Arrangement (RCA)** to provide a **Supplemental Pension** to the owner based on projected "final average earnings" with **contributions tax deductible to the corporation** but, **personal taxation deferred until benefits are received in retirement** (when personal tax rates could be lower than when working). **An RCA can be "wrapped" around an RRSP** or other registered pension like an IPP.

The advantage to the RCA for Private Companies is that there is no funding cap for benefits within these guidelines like there is in an RRSP.

Example:

Prepared for	Ontario Corporation Ltd RCA for Mr. Business Owner	Male Age 50		
Final 5 yr average salary	**$285,401**			
Pension Entitlement	**60% of Final 5 year eligible earnings**			
Total Desired Pension	**$171,241**			
Projected Funded Pension from RRSPs	**$41,713**			
Unfunded Pension Entitlement	**$129,528**	**Indicated Funding**	**$209,451**	**annually**

The RCA vs Pre-Retirement Dividend Payments

For a company with $750,000 in current passive investments growing from after tax profits of $225,175. Using a conservative 3% (relative to eligible dividends portfolio) raises the passive investment ceiling to $1,666,666 without penalty.

Required Dividend Payments to not exceed ceiling

			Corporate Tax at Small Business Rate					13.50%			Passive
Investment	**$750,000**	Annual	Annual to	Total	3.0%	Less IIT	Excess	Neutralizing	Cumulative	RDTOH	Year End
Age	Year	Profit	Passive	Passive	Interest	50.17%	Earnings	Dividend	Dividends	Refund	Balance
50	1	260,318	225,175	975,175	29,255	14,677	(20,745)	0	0	-	989,753
51	2	260,318	225,175	1,214,928	36,448	18,286	(13,552)	0	0	-	1,233,090
52	3	260,318	225,175	1,458,265	43,748	21,948	(6,252)	0	-	-	1,480,065
53	4	260,318	225,175	1,666,666	50,000	25,085	(0)	38,574	38,574	14,785	1,706,366
54	5	260,318	225,175	1,666,666	50,000	25,085	(0)	264,875	303,449	46,332	1,737,913
55	6	260,318	225,175	1,666,666	50,000	25,085	(0)	296,422	599,871	19,165	1,710,746
56	7	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	869,126	19,165	1,710,746
57	8	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	1,138,382	19,165	1,710,746
58	9	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	1,407,637	19,165	1,710,746
59	10	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	1,676,892	19,165	1,710,746
60	11	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	1,946,147	19,165	1,710,746
61	12	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	2,215,402	19,165	1,710,746
62	13	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	2,484,657	19,165	1,710,746
63	14	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	2,753,912	19,165	1,710,746
64	15	260,318	225,175	1,666,666	50,000	25,085	(0)	269,255	3,023,167	19,165	1,710,746

If 209,451 goes to RCA

Conventional Funded RCA				Example 15 years from age 50 to 65					
		Investment Account (RCAIA)				Refundable Tax Account (RTA)			**Total**
Year	Gross		Interest 3%	To RTA	Balance		from RCAIA		**RCAIA + RTA**
1	209,451	104,726	3,142	-	107,867	104,726	-	104,726	**212,593**
2	209,451	104,726	6,378	1,570.88	217,400	104,726	1,571	211,022	**428,422**
3	209,451	104,726	9,664	3,188.89	328,600	104,726	3,189	318,936	**647,536**
4	209,451	104,726	13,000	4,831.88	441,493	104,726	4,832	428,494	**869,987**
5	209,451	104,726	16,387	6,499.88	556,106	104,726	6,500	539,719	**1,095,825**
6	209,451	104,726	19,825	8,193.28	672,463	104,726	8,193	652,638	**1,325,101**
7	209,451	104,726	23,316	9,912.47	790,591	104,726	9,912	767,276	**1,557,867**
8	209,451	104,726	26,860	11,657.82	910,519	104,726	11,658	883,659	**1,794,178**
9	209,451	104,726	30,457	13,429.75	1,032,272	104,726	13,430	1,001,814	**2,034,086**
10	209,451	104,726	34,110	15,228.66	1,155,878	104,726	15,229	1,121,769	**2,277,647**
11	209,451	104,726	37,818	17,054.96	1,281,367	104,726	17,055	1,243,549	**2,524,916**
12	209,451	104,726	41,583	18,909.06	1,408,766	104,726	18,909	1,367,184	**2,775,950**
13	209,451	104,726	45,405	20,791.39	1,538,105	104,726	20,791	1,492,700	**3,030,806**
14	209,451	104,726	49,285	22,702.38	1,669,413	104,726	22,702	1,620,128	**3,289,542**
15	209,451	104,726	53,224	24,642.46	1,802,720	104,726	24,642	1,749,496	**3,552,217**

The RCA eliminates the need to pay pre-retirement dividends totalling $3,023,167 and, stops the reduction of the retirement pool by dividend taxation.

Re-balanced Passive Investment Portfolio

By transferring allowable pre-tax profits to the RCA, the remainder $44,000 net profit annually does not reduce the $500,000 limit for small business taxation when added to the existing passive investments of $750,000

Investments Age		Corporate Tax at Small Business Rate $750,000 Annual Profit	Annual to Passive	3.0% Interest	Less IIT 50.17%	13.50% Excess over $50,000	Reduction x 5	New Limit	Additional Tax at 13%	Cumulative Tax	Passive Investment Balance	Eligible RDTOH Credit 38.33%	Balance	Passive total inc RDTOH
50	1	$50,867	44,000	23,820	11,950	0		500,000	-	-	805,869	9,130	9,130	815,000
51	2	$50,867	44,000	25,496	12,791	0	-	500,000	-	-	862,574	9,773	18,903	881,477
52	3	$50,867	44,000	27,197	13,645	0	-	500,000	-	-	920,126	10,425	29,328	949,454
53	4	$50,867	44,000	28,924	14,511	0	-	500,000	-	-	978,539	11,086	40,414	1,018,953
54	5	$50,867	44,000	30,676	15,390	0	-	500,000	-	-	1,037,825	11,758	52,172	1,089,997
55	6	$50,867	44,000	32,455	16,283	0	-	500,000	-	-	1,097,997	12,440	64,612	1,162,609
56	7	$50,867	44,000	34,260	17,188	0	-	500,000	-	-	1,159,069	13,132	77,744	1,236,813
57	8	$50,867	44,000	36,092	18,107	0	-	500,000	-	-	1,221,053	13,834	91,578	1,312,632
58	9	$50,867	44,000	37,952	19,040	0	-	500,000	-	-	1,283,965	14,547	106,125	1,390,090
59	10	$50,867	44,000	39,839	19,987	0	-	500,000	-	-	1,347,816	15,270	121,395	1,469,212
60	11	$50,867	44,000	41,754	20,948	0	-	500,000	-	-	1,412,623	16,004	137,400	1,550,022
61	12	$50,867	44,000	43,699	21,924	0	-	500,000	-	-	1,478,398	16,750	154,149	1,632,547
62	13	$50,867	44,000	45,672	22,914	0	-	500,000	-	-	1,545,156	17,506	171,655	1,716,811
63	14	$50,867	44,000	47,675	23,918	0	-	500,000	-	-	1,612,912	18,274	189,929	1,802,841
64	15	$50,867	44,000	49,707	24,938	0	-	500,000	-	-	1,681,681	19,053	208,982	**1,890,663**

Even if a company currently has no passive investments, an RCA still offers better efficiency than a dividend strategy and provides greater security from creditors.

Survivor Benefits and Longevity Risk

Spousal payments can be made in an RCA without a spousal rollover of shares and, if the Primary Member is insurable, survivor benefit funding can be transferred to an insurance company to mitigate, the risk of both members living longer.

In golf, the loss of a stroke in the first round may seem insignificant but, in the fourth round could mean the loss of the tournament. Don't make this mistake for your retirement.

For more information and case study for Accountants and CFOs, please contact:
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RcF Retirement Compensation Funding

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