RCF | RETIREMENT COMPENSATION FUNDING

RRSP*Wraps*

for

Private Business Owners

Future Concern

After presenting his recent budget the Finance Minister Mr. Morneau is promising to present a paper later this year that will outline potential tax changes that could affect upper-income earners, particularly those who use corporate structures to pay less tax.

"Going forward, we will close loopholes that result in unfair tax advantages for some at the expense of others," Mr. Morneau told the House of Commons. "We will eliminate inefficient tax measures, especially those that disproportionately hide their identity to avoid pay taxes."

This continuing review is likely to create unease for thousands of small-business owners.

"It's pretty obvious that private companies and their families are under the radar and under attack," said tax expert Kim Moody, who reviewed the budget for the Chartered Professional Accountants of Canada. "There's a perception out there, certainly with academics and some pockets of government, that private corporations are inappropriately used to save tax or defer tax and I think a lot of that is not true, but the government intends to look at that and make their own determination."

Rethinking Retirement

Most business owners pay themselves what they need to live on and, maximize their RRSP. Today, most will also ensure that their after-tax money (net of RRSP contribution) will also allow them to take advantage of the full TFSA Contribution limit.

Excess profits are normally left in the company. Although subject to tax, much lower than personal rates. For those that have the common shares of their Operating Company (OpCo) owned by a Holding Company (HoldCo), net retained earnings not needed by the OpCo for expansion, can be transferred to the HoldCo by way of a tax-free dividend.

In these situations, the HoldCo becomes the "piggy-bank" for long term Wealth Creation. At retirement, the owner can draw down from this "piggy-bank" by paying out dividends (providing continued ownership of common shares). The dividends will be classified as "eligible" or "non-eligible" depending on the corporate tax rate at the OpCo level.

To depend on this strategy for the future could be dangerous.

Retirement Pots

Like a coin, retirement wealth, only has two sides. One requires enough money to live on and to support what success has yielded – "the Living Pots". The other celebrates success – "the Play Pots".

At retirement, what is in the RRSP (or IPP/PPP/MPPP or DBPP) and the TFSA are clearly "Living Pots". But, will these Pots be enough? How much of the wealth built within a HoldCo or sale of company, needs to be allocated to the "Living" side of the coin and, how much can be used to enjoy the success of a lifetime's work, the "Play Pot"?

How then can money, not needed now to live on, or to grow business, be withdrawn from the company, set aside for the future, create both an immediate tax deduction for the OpCo, tax deferral for the owner and, with no long-term requirement for continued share ownership?

The answer lies in what some refer to as a Corporate RRSP or RRSP*Wrap*.

The **RRSP*Wrap***

The Income Tax Act allows a **Retirement Compensation Arrangement (RCA)** to be wrapped around a RRSP 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 received retirement** (when personal tax rates could be lower than when working).

Initially used by large public corporations to fund the difference between what was promised by way of pension and what could be provided by a Defined Benefit Pension Plan resulting from the benefit cap – the "Pension Gap"

"a normal level of benefits would be the same benefit provided under a registered pension plan without regard to the Revenue Canada maximum. This would be 2% x years of service x final five-year average earnings or about 70% of pre-retirement income for an employee with 35 years of service." (CRA Roundtable discussion, 1998).

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

As such, it provides Segmented Wealth Creation by peeling off a layer of pre-tax profits in the OpCo. If these net profits would normally have moved up to a HoldCo, funds that would have been part of HoldCo's retained earnings are, now in a creditor protected Trust.

All eggs are not in the same basket.

Retirement planning that allows greater flexibility for sale and succession planning.

Increased Retirement Benefits

Some business owners can have little in an RRSP or even nothing (if they had been using a dividend only way of paying themselves). Worse still, they could have experienced investment losses in their RRSP in 2008 that, they have not recovered from. **RRSP rules do not allow make up contributions but, an RRSP*Wrap* can.**

The resulting Supplemental Pension usually will provide more retirement income than the RRSP and, could more than double retirement income.

Pension Entitlement	**Age 65**	**60% of Final 5 year eligible earnings**	**Current Age 53**	
Total Target Pension		**$126,941**		
Projected Funded Pension from RRSPs				**$53,670**
Unfunded Pension Entitlement				**$73,271**
Based on 2% x 30 years of service x final average earnings.				

The 2017 RRSP contribution is capped at $26,010 which equates to $144,500 of pre-tax personal T4 earnings. **But, the RRSP*Wrap* contribution to the RCA is based on what is required to fund the gross percentage entitlement of final average earnings at retirement less, what the RRSP produces with, no cap on contributions.**

The current maximum $144,500 is worth more in future dollars. At age 50, with 5% indexing, those earnings at age 65 grow to $300,405.

The final 5 year average of the above is $273,125, for 35 years of service, the gross pension entitlement is $191,187 for life (with a 2/3rdsurvivor benefit) indexed to CPI. Can the RRSP alone produce this? Unlikely

Changes to current taxation reduce the benefits of Business Owners compensated by dividends only. Moving to T4 compensation allows for future RRSP contributions. **The RRSP*Wrap* allows for the catch up of missed contributions relative to past service with employer and investment returns on them.**

The intent to establish a Supplemental Pension with regular annual contributions through an **RRSP*Wrap*** must be clear to avoid the Retirement Compensation Arrangement (RCA) from being deemed a Salary Deferral Arrangement (SDA).

Care must be taken with past service contribution that they are relative to earned benefits and, unless for immediate retirement, future service contributions must be shown.

The Deferral Advantage Myth

Contributions to a Retirement Compensation Arrangement (RCA) are split equally to an Investment Account (RCAIA) and a Refundable Tax Account (RTA). The latter is held with CRA and earns no interest raising the question if it is better to have 50% invested in the RCA or, leave earnings in company, pay the corporate tax and, have more money invested in the OpCo retained earnings account or, sent by tax-free dividend to a HoldCo.

What is forgotten is that, **the RTA may not earn interest but, the funds are there to pay benefits**. It also provides a hedge against investment losses. RCAs fared better than RRSPs in 2008 because only ½ of contributions were at risk.

The additional investment earnings on the spread between the 50% held in the RTA and, the corporate tax rate must first recover what has been lost in corporate tax before retirement. After investment tax, this is hard to accomplish.

In any event, the loss of earnings in the RTA can be mitigated by the use of insured funding in the RCA Investment Account relative to the portion of the contributions allocated to survivor benefits. At death of primary member, insurance benefits cover survivor benefits. The enhanced mortality benefit offsets earnings that have not been made in the Refundable Tax Account.

This can provide (i) unreduced Primary and Survivor benefits at the same funding cost of normal Primary benefits or; (ii) if RCA funded for full Primary and Survivor Benefits, indexing can be added at no additional funding cost.

Care though must be taken to follow CRA's **"Advantage Guidelines"** when life insurance on a Plan Member is an asset in an RCA.

Dangers Lurk

Many initial business successes did not stay ahead of the curve. The stagecoach and livery service lost to the bus and car; couriers lost to the fax machine, the fax machine lost to the internet and scanners; film lost to digital, record companies to downloading, the sub-prime mortgage crisis the housing sector and, the list goes on. Also there is the threat of product liability that HoldCos may not protect in the event of a shareholder action against the OpCo.

Prudence suggests protecting some assets on the way up.

Succession and Sale of Business

Remainder benefits go to designated beneficiaries and, a RCA Trust is not subject to the 21 year rule. Unfunded benefits at time of a sale can be attractive to a purchaser since made pre-tax.

Don't Retire Without One

An **RRSP*Wrap*,** secured and funded by a Retirement Compensation Arrangement (RCA) is another "Living Pot" of assets providing more flexibility in dealing with the OpCo or HoldCo.

By retirement a Business Owner usually also has a significant capital investment in the company. If hit by a lurking danger, Available Investment Business Losses (ABIL) credits can be used to offset taxes on benefits paid from the RCA.

The company would have received deductions of contributions made to the RCA in profitable years with, no tax to the owner. Then, if times have changed at retirement, the owner can access the RCA offsetting personal taxes with ABIL credits.

An RCA makes sense in the good times and, offers greater protection and security in bad times.

Key Employees

They have the same concern as the owner but, fewer options. A **"*Target Benefit*" Group Supplemental Employee Retirement Plan (SERP)** with **vesting at retirement**, can be instrumental in keeping Key Employees working after an owner's retirement or, as they slow down and, enhance the sale of the company.

As headlined by Canadian Business **"77% of Canadians would switch jobs for better retirement benefits"** (study by ADP Canada).

Just as a business owner insures valuable physical assets against fire etc, the long-term retention of just as valuable employees should not be overlooked.

The **RRSP*Wrap* - Something to Think About**

Interested

Call your Financial Advisor

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Securing the Future