Back to Planning for the future now

Planning for the future now

May 06, 2010

Madhavi Acharya-Tom Yew

You've spent a lifetime building your company but now, your golden years are on the horizon.

You're looking for a retirement plan, as well as a succession plan, and you'd like the former to involve a permanent move, perhaps to another province, or even down south.

A retirement compensation arrangement may be one option, experts say.

These trust vehicles can be complex and are not well known, but they may provide an ideal retirement plan in certain circumstances.

When it comes to retirement, small business owners typically have a couple of options above and beyond the traditional options such as selling a business or dipping into a Registered Retirement Savings Plan.

They include an individual pension plan, an insured retirement plan or a retirement compensation arrangement, known as an RCA.

An RCA is a trust agreement involving an operating company and the retiring owners or senior executives. Under a simple arrangement, the business would pay an amount to the RCA, perhaps $100,000, meant to fund their retirement income.

The amount paid must be considered reasonable based on the owner's previous compensation from the company.

In this case, the business can take a tax deduction for the $100,000 it pays into the RCA.

Half of the amount, in this example, $50,000, would be remitted to the Canada Revenue Agency as a refundable tax. The amount is guaranteed, but it does not earn any interest.

The remaining 50 per cent stays in the RCA trust and it's invested on whatever terms laid out in the agreement — GICs or bonds or some other investment. It's important to keep in mind that if the RCA earns interest, dividends or capital gains on the investment, it must pay 50 cents of every dollar gained to the Canada Revenue Agency.

Two or three years later, the RCA may pay the owner, who is now retired.

For every dollar the RCA pays out, Canada Revenue agency will also refund a dollar to the retired owner.

The owners then pay income tax on the entire amount, according to what tax bracket they're in — and it's probably a lower bracket because they are now retired.

The big share of tax that is initially paid on an RCA is one of the disadvantagess of these plans, said Greg Kennedy, a financial planning specialist at Meridian Credit Union.

But one big advantage is that the retired business owner can control the timing of the withdrawals from the RCA, he added.

"If you have a seasonal business and your cash flow is unpredictable, an RCA is ideal. When you retire, you control the withdrawals, not the government. If you don't need the money in a particular year, you can leave the money in the RCA and let it accumulate," said Kennedy, who has 25 years in the financial industry.

In order to pass assets down to the next generation, children can also be named as successor beneficiaries to the RCA. There's no deemed disposition or estate taxes.

"It's a very efficient succession and estate planning tool in the right circumstances," Kennedy said.

In particular, it makes sense if the retiree expects to leave Ontario permanently to move out west or to the U.S., anywhere where the tax bracket is lower, said Paul Woolford, tax specialist and partner in the enterprise group at KPMG in Toronto.

Assume you live in Ontario today and you plan to move to Alberta — for good — in five or six years, you would benefit from an RCA, he said.

"In five years when you retire and move to Alberta for good, and when you take the money out of the RCA, you're going to be taxed at a lower rate compared to what you would have paid had you remained in Ontario."

The rules can be even more complex for a retiree who moves to the U.S., but tax withholding rates can be even more advantageous, Woolford said.

It's best to get a lawyer, and other experts who are familiar with trust agreements to establish an RCA. Retirees should get tax advice in Ontario, as well as wherever they plan to move.