RCF News

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The Accounting Dilemma - RCA vs. Bonus Out

By Roy W. Craik

When Retirement Compensation Arrangements (RCAs) are established for employees, the focus is Pensions, Benefits and "Golden Handcuffs". For Owner/Managers tax must also be addressed. Not only are there different ways (and tax costs) for an Owner/Manager to withdraw money from a corporation, but personal tax rates vary by Province. (see RCF*News* Issue #3 located in the RCF*Library* at **www.rcf.ca**

The Professionals Role

Although some might disagree, the accountant's primary role (other than preparing the company's financial and the owner's income tax returns) is to mitigate the corporation's cash flow at the least tax cost to the owner (shareholders) and to advise as to the most effective way of providing and securing benefits to employees.

Sometimes the "best" option from a purely tax perspective is not the best business or security option when all of the pertinent factors are taken into account. Advice of this nature should probably best come from the company lawyer or the financial advisor. It is not fair to ask the accountant to make business decisions. They provide the tax information and parameters on which the business decisions are based

Conventional Funded RCAs

When the RCA legislation was first introduced in 1986/87, it was tax neutral since both the top corporate and personal tax rates were approximately 50%, more or less equivalent, to the 50% remittance to the RCA Refundable Tax Account (RTA). Since then, personal tax rates have dropped. As such, RCAs are no longer tax neutral, particularly in Alberta.

Non-tax sheltered RCAs funded using investments generating non-tax sheltered Capital gains or dividends, make no sense as assets of an RCA for an owner/manager. The owner/manager would have been better off with the Bonus Out since a capital gain or dividend is received at a lower tax cost then the 50% required payment to the Refundable Tax Account (RTA) for the RCA.

However, fixed-income funded RCAs provide security at small loss of opportunity cost on the difference between personal tax rates and the 50% contribution to the RTA. Lower future personal tax rates and no payroll and health taxes on the contributions to the RCA can further mitigate this loss.

Tax Sheltered RCAs

Most accountants and professional advisors tend to be unaware of the advantages offered if an "exempt" insurance contract like RCFs PENSION***Plus***™. is used as the funding asset in the RCA. For the same cost of funding primary benefits in a conventional RCA, the insured RCA can provide:

- Survivor Benefits
- A pre-retirement death benefit
- No loan arrangements like IRPs (Insured Retirement Plans)
- Attractive fee package
- Professionally managed

Eggs in One Basket

Think back. Who would have predicted the collapse of Nortel, Eatons, etc. etc; the fall-out to small business from the NHL lockout; and the effect of tragedies such as 9/11 with, the resulting loss of business. Not many.

A financial advisor worries most about such things and takes a macro view of the client. Diversification and Prudence are two key considerations.

Is it wise to keep a client's retirement investments in their corporation notwithstanding potential tax savings? Should aggressive investment and tax planning strategies apply to all assets?

Living Money vs. Play Money

Just as most business people take steps to protect their home, if given the opportunity and shown the way, they would also set aside "Living Money" to have a base level of required retirement income. The Income Tax Act provides this through the Retirement Compensation Arrangement (RCA) provisions.

Those that dissuade their clients from taking advantage of such prudent moves, do so at their peril in today's market place. Need we mention Portus. There is nothing wrong with showing the tax costs and investment potential of other alternatives (in fact, it is encouraged) but a client should not be pressured into putting all of their "Eggs in One Basket".

Personal vs. Corporate Tax

Up until recently, most accountants for Canadian Controlled Private Corporations (CCPCs) usually recommended that the earnings subject to the small business tax rate be kept within the corporation and a supplemental pension and/or bonus-out of earnings in excess of the small business level.

The general lowering of corporate tax rates in Canada are having some re-think their strategy. There are three problems with this:

1. The Income Tax Act can be changed and governments are always intent on collecting what they consider to be their due. RPPs and RCAs offer tax deferral and tax sheltering of investment income (to prescribed levels) but personal tax will eventually be paid.
2. Leaving assets in a corporation for a long period that are not needed for corporate growth and that could be used to provide a client with "Living Money" is a dangerous road to follow for theoretical tax savings based on today's Income Tax Act. As well, tax savings are only material if the corporation has no other long-term risks (litigation, business downturn, tax liability, etc)
3. Most accountants do not fully understand the advantages of a tax sheltered RCA using properly designed, "exempt" life insurance contract like R^C^F's PENSION***Plus***™ (for RCA).

Conclusion

Pensions are a very important component of any financial plan or tax planning strategy. RRSPs, MPPPs, RPPS and IPPs are part of the solution. But they are not sufficient for those earners above $125,000. The RCA allows these groups to obtain the same percentage level of pension and provides the owner/ manager with a 100% corporate tax deduction with no tax in the owner/manager hands until benefits start in retirement. The RCA provides long-term tax deferral with the money out of the corporation safe from creditors and personal guarantees.

In financial planning, is not the responsible thing to encourage clients to set aside "Living Money". Normally, there is still lots left over to "Play with". There is not then the same concern if aggressive tax planning or investment strategies fail and criticism or liability to the advisor that follows the old trust company Prudent Person's Rule.

Roy W. Craik, President
Retirement Compensation Funding

RCF is the creator of the PENSION***Wrap***™ (RRSP***Wrap***™/ IPP***Wrap***™/ MPPP***Wrap***™) and PENSION***Plus***™. RCA trust services are provided by BMO Trust Company.

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Retirement Compensation Funding Inc
416.364.6444 | info@rcf.ca | www.rcf.ca