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Retirement and Estate Solutions Using Excess Funds in a Corporation

Surplus Cash in a Corporation - Part 4

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As the owner-manager of your operating company, you may have surplus profits accumulating in your corporation. This surplus cash could be in your operating company or it could be in your holding company. In either case it is still a corporate structure and the tax implications are the same.

Your first reaction may be to figure out how to withdraw the funds from the corporation and pay as little income tax as possible. While this might seem the best solution, other options might be more appropriate depending on your situation and your personal and business needs.

There are many issues to consider when deciding what to do with your corporation's surplus funds. What do you need the money for most? What options are available? And what are the tax implications of those options?

This article, the last in the series on surplus cash, discusses some retirement and estate planning solutions you may consider if you don't have an immediate personal or business need for your corporation's surplus cash.

This four-part series takes you through some of the key issues to consider when you have surplus cash in your corporation:

Part 1: Decision tree for addressing surplus cash in a corporation
Part 2: Taxation of investment income in a corporation
Part 3: Methods of withdrawing cash from a corporation
Part 4: Retirement and estate solutions using excess funds in a corporation

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian controlled private corporation (CCPC). This means that the corporation is not controlled by a non-resident of Canada or a public corporation and no class of shares of the corporation is listed on a prescribed stock exchange. This four part series does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

When there’s no personal or business need for the cash

Even if you have decided that the excess funds in your corporation are not required for business or personal purposes in the short to medium term, you still need to decide whether to retain the excess funds in your corporation or withdraw them.

In general, the best course of action may be to get the funds out of the corporation in a tax-efficient manner because, in most provinces, investment income is taxed slightly higher in a corporation than personally, even at the highest personal tax rates.

As with any planning, when you’re deciding whether to keep the funds in your corporation or take them out, a good place to start is by understanding and defining your goals and objectives.

What are you going to use the funds for?

At this point, you have already determined that there is no short or medium term use for these funds, so you need to think longer term. There are two likely conclusions: you are going to use the funds yourself for retirement or you want the funds to enhance the value of your estate or a combination of the two.

Retirement

You should have an idea of how much money you need for retirement before you proceed with this analysis. The solution for a retirement goal may be different from the solution for an estate goal, and you do not want to be in the position of implementing an estate solution that is not reversible if you need to use these assets to fund your retirement.

Some possible strategies for a retirement goal include:

Dividends — Accumulate excess assets in the corporation and pay dividends in retirement when you may be taxed personally at a lower rate.

Salary — Pay yourself sufficient salaries and/or bonuses during your working years to allow you to maximize your RSP contributions.

Insured retirement plan — Buy a permanent insurance policy that allows you to invest the premiums in excess of the pure cost of the life insurance. These invested funds grow on a tax-sheltered basis. When funds are required for retirement, you may be able to borrow using the cash surrender value of the policy as collateral for the loan. Upon death, the non-taxable death benefit is paid out and used to repay the loan. Any excess funds left after the loan is repaid go to your estate. If you are going to use the insurance policy as collateral for a personal loan, it may be better to own the policy personally rather through your corporation.

Retirement compensation arrangement (RCA) — Your corporation may deposit funds into a trust that is an RCA. The corporation gets to deduct the amount contributed to the RCA when calculating its tax. Of the total contribution made to an RCA, 50% is deposited with the custodian of the RCA Trust to be invested, and the other 50% is deposited with the Canada Revenue Agency (CRA) as a refundable tax. In addition, 50% of all dividends, realized capital gains, and interest income less expenses earned in the RCA, must be remitted to the refundable tax account on an annual basis. In retirement, you withdraw the funds from the RCA, hopefully when you are in a lower tax bracket. When benefits are paid to you from the RCA, $1 of refundable tax is recovered from CRA for every $2 paid out of the RCA.

Individual pension plan (IPP) — Your corporation may contribute to an IPP for your benefit. Your corporation can deduct the contributions, and the funds in the IPP grow tax-sheltered until you withdraw them in retirement. The funds you receive in retirement from the IPP are taxable at that time at your marginal tax rate.

Estate

If you decide to use the surplus funds in your corporation to increase the value of your estate, there are a couple of interesting strategies you can use involving insurance, which offers tax-sheltered growth and a tax-free death benefit:

Corporate estate bond — Buy a permanent insurance policy that allows you to invest the premiums in excess of the pure cost of the life insurance. These invested funds grow on a tax-sheltered basis and are paid out tax-free to your beneficiaries upon your death. The combined effect of tax-sheltered compounded growth and a tax-free payout makes this an attractive strategy.

Insured annuity ("back to back") — In some cases funds will be required either for business purposes or for retirement. Excess funds can be used to purchase an annuity. The income from the annuity is then split. A portion is used to pay the premiums on a permanent insurance policy with a death benefit equal to the capital used to buy the annuity. This preserves the capital. The rest of the income from the annuity can be used for business or retirement purposes. This is generally suitable if your investment alternative is a conservative fixed-income strategy.

These insurance-based estate strategies can also be implemented personally, but this is generally not as effective when the excess funds are inside your corporation especially since the insurance proceeds can be paid out of the corporation tax-free through the capital dividend account. It will cost you to withdraw the funds from the corporation to implement the strategy personally.

These strategies can be complex and we have only highlighted them here. We suggest you get more information and fully understand them before you proceed.

Qualifying small business corporation

Maintaining investments or an insurance policy in your corporation can affect your company's status as a qualifying small business corporation and your succession plans.

For example, these assets may disqualify the shares of your corporation as qualifying small business corporation (QSBC) shares so that the $750,000 capital gains exemption may not be available to you on the actual or deemed disposition of your shares. In addition, a potential purchaser may not want to deal with the implications of the corporation owning an insurance policy on the previous owner's life. There may also be tax consequences to changing the ownership of the insurance policy.

Consequently, it may make sense to establish a holding company to maintain the insurance policy as opposed to maintaining it in the operating company. Because this type of structure can complicate your business succession plan, it is extremely important you get qualified professional advice when implementing this type of structure.

Creditor protection

Accumulating excess cash in your operating company means that the funds are exposed to claims from your corporate creditors.

One approach to mitigate this issue is to transfer the excess cash into a holding company. There are various ways to do this. However, as mentioned before, this type of planning can be quite complex and it is advisable that you consult with a qualified tax professional that is experienced in this area.

Any creditor protection strategy that you put in place may be undermined if you have provided personal guarantees. In addition, as a director of your corporation, you may be personally obligated for certain liabilities of your corporation.

You should consult a legal professional regarding creditor protection issues.

Conclusion

There are many opportunities and solutions available to assist you in meeting your retirement and estate planning goals. However, because of the complexity of integrating your corporate and personal goals, considering the different tax systems, it is essential that you involve the appropriate professionals in order to maximize these opportunities and accomplish your goals in the most tax-effective manner.