Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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PRIVATE INVESTMENT MANAGEMENT™

Retirement and estate solutions using surplus cash in a corporation

As a business owner, you most likely rely on the income generated by your corporation's business to fund your lifestyle. You may also hope that your business accumulates sufficient capital to meet your income needs in retirement. If so, you should consider your long-term objectives for any surplus cash accumulating in your corporation, whether they involve boosting your retirement savings or enhancing the value of your estate. This article discusses possible retirement and estate planning strategies relating to your business featuring tax-sheltered growth and tax-free payouts.

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of the CCPC can be listed on a prescribed stock exchange. This article does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

Define your goals and objectives

You have surplus cash that has been accumulating in your corporation over the past number of years. You have determined that you do not need the surplus cash for either personal or business purposes in the short- to medium-term. You are now thinking about the long-term opportunities available for the excess cash. As with any planning, a good place to start is by understanding and defining your goals and objectives. Do you wish to use these excess funds to boost your retirement income, enhance the value of your estate, or a combination of the two?

Before you begin implementing any solution, you should have an idea of how much money you will need in retirement. It wouldn't be advisable to implement an estate planning solution, sometimes an irreversible one and later find it conflicts with your retirement needs.

Retirement solutions

If you decide to use the surplus cash in your corporation to fund or increase your retirement income, consider the following strategies which may help achieve your retirement goals.

Deferred dividends

Where you have determined that it is better to retain the after-tax business income in your corporation for reinvestment and wish to continue doing so, consider deferring the payment of dividends to a future year. For example, it may make sense to defer the payments until your retirement, when you may be taxed personally at a lower rate. Please note that this strategy may maintain the deferral of personal tax on the invested income but does not provide tax-sheltered growth since the investment income will be taxed in your corporation in the year it is earned.

Further in your planning, it is important to be cognizant of how any additional passive income generated in your corporation may impact your access to the small business deduction (SBD). The SBD lowers the federal corporate tax rate on the first $500,000 (known as the small business limit) of active business earned in a CCPC. For taxation years that begin after 2018, a CCPC's access to the small business limit may be restricted if it has significant income from passive investments. Under this measure, the business limit is reduced on a straight-line basis for a CCPC and its associated corporations that have between $50,000 and $150,000 of investment income. This measure reduces the business limit by $5 for every $1 of passive investment income above the $50,000 threshold. The business limit is eliminated if a CCPC, and its associated corporations, earn at least $150,000 of passive investment income in a year. For more information on these rules relating to passive income, please ask your advisor for our article on Passive Investment Income in a Private Corporation.

Depending on the extent of active business and passive income earned in the corporation, you will need to weigh the possible benefit of a deferral against the claw back of the small business limit, if applicable.

Individual Pension Plan (IPP)

Your corporation may set up an IPP for you, as well as certain family members if they are also employees of your company. An IPP is a defined benefit registered pension plan and its purpose is to maximize your tax-sheltered retirement savings. An IPP can also provide you with

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possible creditor protection. Contributions made to an IPP are deductible from your corporation's income. In addition, the funds contributed to the IPP grow tax-sheltered until you withdraw them in retirement when they are taxed at your marginal tax rate. An IPP is ideally suited for individuals over the age of 40 who earn significant employment income.

Retirement Compensation Arrangement (RCA)

Your corporation may deposit funds into an RCA, which is a trust arrangement. The purpose of an RCA is to provide you with supplemental pension benefits and distribute the funds to you upon your retirement. An RCA can also provide you with possible creditor protection. Contributions made to an RCA are deductible from your corporation's income. Of the total contribution made to an RCA, 50% is deposited with the custodian of the RCA to be invested and the other 50% is deposited with the Canada Revenue Agency (CRA) as a refundable tax. In addition, 50% of all income earned and capital gains realized less expenses in the RCA, must be remitted to the refundable tax account with the CRA on an annual basis. In retirement, you withdraw the funds from the RCA, ideally 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. It is possible to recover 100% of the refundable tax once the RCA has completely paid out the benefits to you.

Corporate insured retirement plan

Your corporation may apply for a tax-exempt life insurance policy that allows it to make additional contributions to the policy above and beyond the annual policy premiums (within certain limits). These contributions are invested with the funds growing on a tax-sheltered basis. When funds are required for retirement, the cash surrender value of the policy may be used by your corporation as collateral for loans. The funds borrowed by your corporation are then used to provide retirement income to you.

Upon death, the insurance proceeds are paid to your corporation tax-free, creating or increasing your corporation's Capital Dividend Account (CDA) in the amount of the insurance proceeds in excess of the policy's adjusted cost basis. The insurance proceeds may then be used to repay the loan. Your corporation then uses the proceeds from the life insurance (and any other capital) less the funds used to repay the loan to pay a dividend to your estate, the majority of which should be a tax-free dividend as a result of the CDA balance from the insurance proceeds.

Further, provided the insurance policy is an exempt policy, income from the policy would not be included in the passive income calculation discussed above with respect to the small business limit reduction.

Corporate insured annuity

A portion of your corporation's fixed income investments could be used to purchase a non-prescribed annuity and a life insurance policy (to replace the capital used). The annuity would generate an income stream that would cover the cost of the life insurance premium and the tax on the annuity, as well as generate income which could be used to supplement your cash flow.

When you pass away, your company would receive the tax-free death benefit from the life insurance policy. The excess of the death benefit over the adjusted cost basis of the policy is credited to your corporation's CDA. Your corporation then uses the proceeds from the life insurance to pay a dividend to your estate, the majority of which would be a tax-free dividend as a result of the CDA.

The above two insurance-based strategies can also be implemented personally but this may not be as tax-efficient when the excess funds are inside your corporation and you don't have sufficient personal cash flow to pay the premiums. This is because you would first need to withdraw funds from the corporation and pay personal tax before using the after-tax amount to fund the insurance strategies.

Estate planning solutions

If you decide to use the surplus cash in your corporation to increase the value of your estate, consider the following strategy involving insurance, which offers tax-sheltered growth and a tax-free death benefit.

Corporate wealth transfer

Your corporation can apply for a tax-exempt life insurance policy and would be the owner and beneficiary of the policy. Premiums may be paid from excess cash flow or from the reallocation of existing retained earnings. These premiums will generally not be tax deductible. However, these invested funds grow on a tax-sheltered basis. Upon death, the insurance proceeds are paid to your corporation, tax-free, which creates or increases the CDA by the amount of the insurance proceeds received in excess of the policy's adjusted cost basis. Your corporation then uses the proceeds from the life insurance to pay a dividend to your estate, the majority of which would be a tax-free dividend as a result of the CDA.

Provided the insurance policy is an exempt policy, income from the policy would not be included in the passive income calculation with respect to the small business limit reduction.

Other considerations

Lifetime Capital Gains Exemption (LCGE)

If you plan on eventually selling the shares of your private corporation, you may be able to claim the LCGE on the sale of the shares if your corporation is a qualified small business corporation (QSBC). Maintaining investments or insurance policies in your corporation may affect your company's status as a QSBC and, as a result, your succession plans. For example, if more than 10% of the assets in your corporation are passive investment assets, your private company shares will not qualify as QSBC 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. Consequently, you may consider restructuring the corporate assets prior to the sale, especially if you own a life insurance policy inside the corporation. Keep in mind that there may be tax consequences to changing the ownership of the insurance policy or other assets inside your corporation.

It may make sense to establish a holding company to maintain the passive assets or insurance policy as opposed to keeping it in your operating company. This type of restructuring can complicate your business succession plan so it is extremely important you get qualified professional advice before taking any action.

Creditor protection

Accumulating surplus cash in your operating company means that the funds may be exposed to claims from your corporate creditors. One approach to mitigate this issue would be to transfer the excess cash to a holding company. This may protect those earnings from creditors of your operating company. Please note that any creditor protection strategy 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.

It is essential that you speak with a qualified legal advisor regarding any creditor protection options available to you. You may also wish to speak to a qualified tax advisor about the tax implications of moving the funds from your operating company to a holding company.

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, 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.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.