The Simple Strategy Business Owners Use To Retire Comfortably

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For Canadian business owners, interest in estate and retirement planning is growing. There will come a time when tough decisions will have to be made concerning their retirement and whether to fully or partially step away form their business and eventually hand it over to their children. Once that decision has been made they will want to explore their retirement options.

Their goal is two-fold: Maximize their retirement income and personal estate values while minimizing corporate tax on death. In other words, generate a fixed amount of income from their business while maintaining the capital they have built in their business to pass on to their children. This is nothing new. This is what successful business owners have been doing generation after generation.

Since their corporation has built significant retained earnings over the years and most of their investment capital is tied up in their company, this is where they would draw their retirement income. A large portion of their retained earnings are usually invested in traditional fixed-income investments such as GIC's and bonds. The income received from these types of investments are considered investment income to the corporation and taxed at its highest rate (46.17% in Ontario). The owner/shareholder would then be taxed on the dividends as they receive them and assuming they are paid as non-eligible dividends the personal marginal tax rate would be 36.47% in Ontario. With such a high tax rate many business owners will be looking for an alternative investment to help them reduce taxes paid and increase their net after-tax retirement income. A simple strategy successful business owners have been using is known as--the corporate back to back strategy.

A corporate back to back arrangement offers several benefits such as; improving annual cash flows for a higher lifetime retirement income stream. Retention of business capital and enhancing estate values, while reducing the capital gains tax liability that arises from the deemed disposition of the owners shares at death. Shareholders of private corporations who require these benefits and prefer conservative investments would do well to investigate this strategy. Advisors should recommend only a portion of their client's corporate funds be allocated to this strategy. Important this is a part of their overall financial plan.

How It Works

A corporate back-to-back strategy s requires the corporation to purchase two separate financial products: a single life (or joint life) annuity and a life insurance policy.

First, the company would purchase the life insurance policy, either a term-to-100 or universal life minimum funded policy. The corporation would be the owner and beneficiary of the policy. This step would ensure that the capital used to fund the retirement is placed back into the company on death. Once the insurance is in place the next step would be to purchase the annuity. (Important, the insurance policy is issued prior to purchasing the annuity because the life insured must qualify medically for the insurance plan and the annuity cannot be unwound once it is purchased.)

The annuity could then be structured with either a single life or joint lives with a spouse. If joint lives are used this would increase the investment returns by lowering the cost of the insurance policy. The annuity payments will be based on the life of the shareholder, with the corporation being the holder of the annuity. The annuity should not have a guaranteed period because it reduces the annual annuity payments (the insurance policy will replace the capital used to buy the annuity.) The annuity will be non-prescribed and subject to accrual taxation.

The corporation would commence receiving the annuity income stream. Income tax would be paid only on the taxable portion of the annuity. The taxable portion of the annuity would be less than other guaranteed investments. Less tax payable means an increase in cash flow to the corporation. With the increased cash flow, the corporation can use some of the annuity income to pay for the insurance policy. The income left form the annuity after paying the taxes and insurance premiums can be distributed to the business owner as a dividend, salary, or bonus to help support their retirement.

On the death of the owner (or second spouse), the shares of the corporation will be deemed disposed of at fair market value which would result in a capital gains tax that must be paid to settle the estate. All investments held in the corporation will be used to determine the value of the shares. This is where the life insurance policy comes into play. The death benefit proceeds from the insurance policy will generally be received on a tax-free basis through the corporations capital dividend account (CDA), in the amount of the proceeds less any remaining adjusted cost basis of the insurance policy. A tax-free capital dividend can then be paid, from the corporations CDA to the corporation's estate.

This beneficial tax treatment of life insurance products payable at death with the ability to flow all or a portion of the death benefit through the (CDA) is an advantage given to Canadian controlled private corporations.

Case Study-Ontario Home Builder

Last year we visited our client Anthony who owned and operated a successful homebuilding company in the Greater Toronto Area. He was 74 and his wife Mary was 70, both were in fairly good health. The company had grown substantially and had accumulated about 8 million in assets split between his operating and holding companies. During one of our meetings, Anthony expressed an interest in semi-retirement and handing over the day-to-day operations of his business to his three children, who were already actively running the company. He was ready to draw an income from his corporation's holding company (valued at 3 million), but wanted to preserve that amount to his estate because of the significant capital gains tax problem his children would encounter upon his death.

The first item we took care of was preserving the 3 million capital in his holding company he would use to fund his retirement. The fair market value of his company was valued at 8 million. The company had no capital gains exemption left and the adjusted cost base was zero. The capital gains tax payable on death would be close to $1,918,800. The solution was to purchase a corporate-owned joint last-to-die insurance policy to replace the corporation's 3 million asset upon death and help pay for the capital gains tax. On the second death when the children received the company and the insurance proceeds, could be credited to the company's CDA account. That meant the children would receive the insurance proceeds tax-free to fund the capital gains tax liability.

Once the insurance was in place, the next item was maximizing Anthony's retirement income with as little investment risk possible. Anthony felt he needed to be able to withdraw close to $75,000 every year from his company to cover basic expenses during retirement.

In order for Anthony to start drawing an income, he would have to liquidate his corporate holdings. Presently, these corporate assets were heavily invested in fixed-income investments, earning about 2-4%. The corporation would start to liquidate these investable assets and use the proceeds to purchase a non-prescribed corporate–owned joint life annuity. The annuity would provide a guaranteed income stream to the company as long as Anthony and Mary are living. The annuity income would be taxed to the corporation at its corporate tax rate. Income will flow to the shareholders as taxable dividends. A portion of each annuity payment would be used to fund the insurance policy. Even after paying the insurance premium, the corporation's net cash flow will be better than the corporately held GIC and bond net cash flow.

Corporate Back-To-Back Annuity	Vs.	GIC at 3%
3 Million	Principal You Invest	3 Million
$175,719	Annual Income To Corporation	$90,000
$49,789	Taxable Portion (average used for non-prescribed annuity)	$90,000
$23.88	Corporate Tax Payable at 47.97%	$43,173
$151,838	Net After-Tax Income	$46,827
$74,940	Life Insurance Cost	N/A
$76,898	Net Income Available To Distribute To Shareholder	$46,827
3 Million	After-Tax Benefit to Shareholder Estate	$1,905,900
$1,199,250	Capital Gains Tax on Death of Second Spouse	$1,918,800

The comparison chart shows that on average the corporate back to back annuity will have a higher net cash flow of $30,071 per year. That's a 64% higher net cash flow compared to a corporately held traditional GIC and bond. Even if the GIC and bond rate were set to 4% the net cash flow from the annuity would still be higher by about 23%. You would need a guaranteed rate of return on your GIC and bond close to 5% to achieve the back to back annuity net cash flow. In today's low interest rate environment, that would be difficult to achieve.

On the business owners' death the corporation would receive $3 million and credited to the capital dividend account. A tax-free capital dividend can then be paid to their children. If we did nothing and the 3 million had been left as a fixed income investment in the company, it would on the second death net only $1,905,900 to the beneficiaries (1,094,100 tax paid on non-eligible dividends.)

The net result was that the net income available for life to distribute to my client was 64% higher using this simple strategy. His capital gains tax was reduced by $719,550, with the 3 million he used for his retirement income going back to the children tax-free on the second death.

In the right circumstances, corporate annuities can generate the highest guaranteed income for life compared to all other retirement products. They're the only income product that has guaranteed payments that may be indexed to inflation for life. They're perfect to cover basic expenses.

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