business practice

Financial information specifically for dental professionals.

OD Financial Planning

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Giving Employees Their Due

I recently met with a dentist who owns eight dental practices in Southern Ontario. For the last 10 years he'd been paying bonuses to his key employees based on his profits. However, he was concerned that after deducting all required taxes on their behalf, those employees would be left with less than 60 percent of what he'd intended to share with them. He asked me if there was an employee benefits plan through which:

- Contributions could be easily reduced in years he was not profitable; and
- His employees could receive their entire bonus in a tax-effective way.

Though not widely used in Canada today, Deferred Profit-Sharing Plans (DPSPs) are a powerful employee benefit tool and an excellent way of attracting and retaining top-notch personnel.

Profit-sharing plans were very popular in Canada during the Second World War. In 1941, the Canadian government placed strict wage freezes on the entire economy, but employers providing DPSPs were able to offer additional compensation to their employees without actually raising wages. In 1951, the Canadian government removed these wage freezes and DPSPs lost their popularity. Other deferred income plans, such as the defined benefit pension plan (DBPP) and defined contribution pension plan (DCPP), have since become more common.

How Deferred Profit-Sharing Works

DPSPs reward employees for helping a dental practice earn profits. Under these plans, an employer shares the pre-tax profits of his or her business with either all or a designated group of employees.

Under a DPSP the usual amounts payable to the employee by the employer are calculated as a portion of profits, but they may also be a fixed dollar amount per plan member or a fixed percentage of payroll. This decision rests with the employer. Employer contributions to a DPSP are limited to a maximum of 18 percent of an employee's annual salary. However, the overall dollar limit for a yearly contribution cannot exceed $10,000 for 2007, $10,500 for 2008 or $11,000 for 2009. From 2010 on, the limit will be indexed to the average industrial wage.

Deposits made into a DPSP and administration fees are tax deductible for an employer/dental practice owner. Monies within these compensation plans accumulate tax-sheltered for the benefit of the employees (or former employees) until paid out according to rules in the Income Tax Act. In those years an employer/sponsor is not profitable, he or she need only contribute one percent of an employee's income to the DPSP.

When Would a DPSP be Beneficial?

Deferred profit-sharing plans are a good choice for employers who:

- follow a routine policy of 'bonusing-down' to the small business limit (currently $400,000 federally. ('Bonusing-down' refers to paying bonuses or additional salary to key persons within an incorporated business to create a business expenses to keep the corporate earnings below $400,000 where a Canadian Controlled Private Corporation receives favorable tax treatment from CRA).
- are expecting a large, one-time increase in income (possibly from the sale of a practice); and
- have regulatory requirements or a business structure

preventing them from effectively splitting income with family members.

Under certain circumstances, a DPSP may be used as an alternative to traditional remuneration strategies to effectively defer tax and facilitate income splitting.

DPSP Limitations for the Employer

Despite their many advantages, DPSPs cannot be used in every situation. A 'connected person,' i.e. an individual, who directly or indirectly owns more than 10 percent of a company, is not eligible to participate in a DPSP. All DPSPs must comply with Revenue Canada regulations that require either a corporate trustee, e.g. a trust company, or a three-person trust, with at least one trustee being fully independent of the employer and plan member(s). All trustees must be residents of Canada.

Unlike a group registered retirement savings plan (RRSP) or pension plan, only employer contributions are allowed into a DPSP. Most employers use a DPSP to complement a non-contributory group RRSP (that is, an RRSP with no employer contributions).

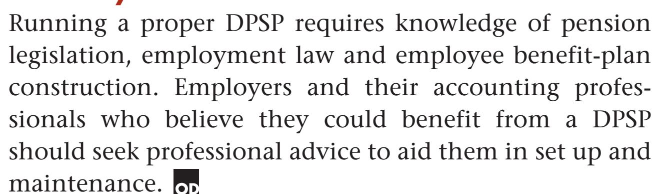
DPSP Limitations for the Employee

Contributions are not added to an employee's earnings and are not subject to payroll taxes such as employment insurance (EI) and the Canadian Pension Plan (CPP). In fact, DPSP contributions reduce the dollar amount an employee can contribute into his or her RRSP by the same dollar amount the employer deposits into the DPSP on the employee's behalf. The RRSP contribution limit reduction shows up as a pension adjustment (PA) amount on the employee's T4.

Contributions become the property of the DPSP member/employee after two years. The employee usually has the right to withdraw vested benefits from the plan at any time. Contributions may be cashed out by the employee member or used to purchase an annuity.

Depending on the plan, DPSP members may withdraw their holdings while still employed. Terminated employees may withdraw the full vested amount subject to taxation.

Summary



Running a proper DPSP requires knowledge of pension legislation, employment law and employee benefit-plan construction. Employers and their accounting professionals who believe they could benefit from a DPSP should seek professional advice to aid them in set up and maintenance.

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