Often overlooked, employee profit plans give more control

MERRICK

By PETER MERRICK

Established under section 144(1) of the *Income Tax Act*, the employee profit sharing plan is a special purpose trust that allows the beneficiaries of the plan to share in the profits of a company.

The allocations to an EPSP are taxable in the hands of an employee, and a deductible expense for an employer.

EPSPs are non-registered savings plans in which the employer contribution is computed by reference to company profits. The minimum employer contribution is one per cent of current year profits or $100 per employee per year.

Under an EPSP, investment earnings are taxable, any vesting rules or withdrawal restrictions may be established, and no maximum contribution limits or investment restrictions apply.

Both employer and employee contributions are permitted—however employer contributions are taxable as income to the employee and tax deductible as a compensation expense to the company.

Advantages of the EPSP

• They attract neither Employer/Employee Canada Pension Plan or EI contributions.
• They allow for more control over retirement assets.
• They are treated as pension and /or RRSP eligible earnings.
• Source deductions and withholdings are not required by the EPSP trustee or employer.
• The allow for income splitting opportunities.
• All amounts paid from an EPSP to an employee are not subject to a reasonableness test, unlike salaries.
• The 'kiddie tax' rules should not apply to income received by minor children from an allocation from an EPSP, if they are *bona fide* employees of the business.
• Contributions to the EPSP can be made up to 120 days after a corporate year end.

How it works

A trust called the Employee Profit Sharing Plan for XYZ Company is set up using a three-person trust agreement. The company makes the contribution to the trust.

All funds in the trust account must be allocated to the participants of the plan at the end of the fiscal year. The company issues a T4PS (profit sharing) slip. These earnings are RRSP and IPP eligible.

Loss or reduction of EI and CPP benefits can be offset by properly investing the savings. In most cases flexibility to invest these contributions should more than make up for the lost benefits.

EPSP's –Maximum Combined Employer and Employee Contributions

Year	CPP	EI	Total	Percentage Increase
1966	$158.40	-	$158.40	-
1975	$241.70	$323.44	$564.64	256%
1985	$759.60	$1,348.88	$2,108.48	273%
1995	$1,701.00	$3,051.38	$4,752.38	125%
2000	$2,659.80	$2,245.20	$4,905.00	3%
2002	$3,365.20	$2,059.00	$5,424.20	11%
2004	$3,663.00	$1,853.28	$5,516.28	2%
2005	$3,722.40	$1,825.98	$5,548.38	1%

What you need to know

The chart above shows what working Canadians and their employers have been contributing to CPP and EI.

Case study—a practical application for investing CPP contributions

Imagine the owner of a Canadian Controlled Private Corporation establishes an employee profit sharing plan for the year 2006.

In the first year both this business owner and his spouse are the only beneficiaries of the plan, and each earn more than $41,000 of profit-sharing income (through the EPSP trust).

The business owner, his spouse and his CCPC will not need to make any further CPP contributions.

After establishing the EPSP the savings will include employer/employee CPP contributions equaling 3,722.40 each, or $7,444.80 combined.

If the business owner decides to invest the $7,444.80 CPP savings into a balanced portfolio that earned 7.5 per cent annually

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The implicit risk of investing

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side risk. To account for fluctuations in returns see the simulation below.

One hundred different scenarios have been run with variable rates of return in each case. This paints a very different picture from the original fixed rate projection.

The following graphs indicate that somewhere in the order of 50 per cent of the portfolios have value remaining when Ann turns 98.

In other words there is a 50-per-cent chance that the $1-million portfolio will last till age 98. An astounding revelation given the initial simplified projection!

Ann's variable rate projected investment values
(See graphs 1 and 2)

If we assume that Ann is in good health we can expect Ann's life expectancy to be approximately age 90. There is a 75-per-cent likelihood that she will able to spend $50,000 each year until age 90 based on the variable projection.

Is she going to be comfortable with a 75-per-cent success rate on this important goal? If not, then the obvious question is how do we improve the success rate and plan for downside risk of returns?

There are some techniques that can be used to improve the success rate and mitigate the downside risk of portfolio return shortfalls.

The first and arguably simplest method is the preservation of capital, especially in the early years of retirement. If you lose capital in the early years it will take away from future growth potential as you will have less of a base to grow from.

Losses later in retirement are not as debilitating because by then the portfolio will have achieved its expected returns and there are fewer years remaining to plan for. Preservation of capital usually occurs by reallocating your portfolio with a greater emphasis on fixed income generating assets, in other words moving from stocks to bonds/cash. Another general technique is to hedge your portfolio using options, futures or diversification into non-correlated assets.

To give the topic of hedging justice would take more space than is available here, so without getting into too much detail, hedging minimizes the risk of significant losses by reducing the volatility of the portfolio.

The two general strategies noted above will help to improve the success rate of your retirement goals and to manage potential downside risks, but there is no substitute for annual retirement planning review.

Periodic review of your financial situation will indicate whether you are on target and allows for practical adjustments that don't have to be too radical or painful. It may only take a modest adjustment to a long term goal to still achieve success.

Why should the accountants reading this article be concerned with the financial planning risk outlined above?

Well, if you have read my previous articles you probably already know the answer. Based on surveys conducted with the clients of many public accounting firms, it is clear that clients feel that their accountant is their "primary" financial advisor.

The top three topics that clients want to discuss with their accountants are retirement planning, estate planning and overall wealth management.

Important risks such as return shortfalls can be valuable information for clients and provide accountants with another opportunity to add value to their service.

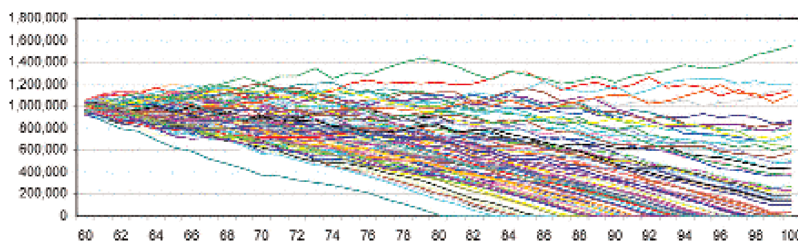
Financial planning, properly structured can be a highly profitable business that is a very logical fit with current accounting and tax services. Just ask your clients if it makes sense.

To be successful requires an individual with a specialization in the field. Unfortunately many accountants that possess the knowledge simply do not have the time to implement financial planning services in their firms.

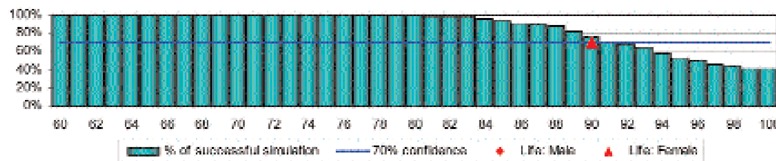
To successfully implement financial planning into an accounting organization and thereby take full advantage of its opportunities, the firm will require an in-house financial planner that is fully integrated with the rest of the accounting practice.

When you pause after your busy season and reflect on what you are going to do differently to make your business successful consider the integration of financial planning.

GRAPH 1



GRAPH 2



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Income splitting

Tax savings can be significant

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within an Individual Pension Plan or RRSP within 10 years he will have accumulated $15,344.

Now let us take this a step further. If our owner invests both the employer and employee CPP contribution into an RRSP each year in the same balanced portfolio that compounds annually at 7.5 per cent, assuming his contributions will rise with the average industrial wage rate of 2.5 per cent per year for the next 25 years until he turns 69 years old and has to withdraw funds from a RRIF, our owner will have contributed $254,305 into his RRSP that would have been ear-marked for CPP contributions.

The value accumulated within his RRSP before it needed to be commuted into a RRIF at age 70 would be $679,390.

Lastly, imagine that this business owner decides to keep the investments mix within his RRIF the same that earns 7.5 per cent annually. From age 70 to 100 our business owner will be able withdraw a total of $1,772,590 in RRIF payments and there will be a remaining balance in the plan at age 101 of $131,977.

Case study two—income splitting opportunity *Note: Difference in net tax payable and net family income with EPSP: is $15,275 in 2006 dollars. The tax savings could even be greater if the business owner employed his children and they where members of the EPSP as well.*

If the business owner and his spouse invested their combined savings of taxes and CPP contributions of $22,719.80 ($15,275 tax savings plus $7,444.80 CPP contribution savings) into RRSPs, and the portfolio compounded annually at 7.5 per cent, assuming their contributions rise with the CPI rate of three per cent per year for the next 15 years until they retire, at age 69 when they will have to start withdrawing these funds from a RRIF. The value accumulated within his RRSP would have grown to $2,173,498.

If he keeps the investments mix within his RRIF the same growing at 7.5 per cent annually, from age 70 to 100 he will be able withdraw a total of $5,670,854 in RRIF payments and there will be a remaining balance in the plan at age 101 of $422,220.

Obviously, EPSP requires a specialty in areas such as accounting, legal, employment and tax law and employee benefit plan construction.

Many employers and their accounting professionals will need to seek educational services to aid them in the EPSP setup, maintenance and wind-up stages.

Therefore, it is worth the time and money to hire an employee benefit consultant to assist in the design, implementation, maintenance and wind-up of an EPSP solution.

Business Owner's Gross Income:	$175,000
Income Tax Payable on Income:	$64,400 (36.8% Average Tax Rate)
After Tax Income to Owner:	$110,600

An EPSP is established for the owner and his spouse who is an employee of the CCPC

Business Owner's Gross Income:	$100,000
Spouse's Gross Income:	$75,000
Income Tax Payable to Owner:	$30,000 (30% Average Tax Rate)
Income Tax Payable to Spouse:	$19,125 (25.5% Average Tax Rate)
Total Tax Payable:	$49,125
Net Income to Owner:	$70,000
Net Income to Spouse:	$55,875
Total Net Family Income:	$125,875

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AIG reaches $US1.6b settlement

The BOTTOM LINE

In one of the largest regulatory settlements ever, American International Group Inc. has agreed to pay more than US$1.6 billion to settle allegations that it used deceptive accounting practices to mislead investors and regulators.

The settlement announced by New York Attorney General Eliot Spitzer's office also requires the New York-based company, one of the world's largest insurers, to adopt changes in its business practices to ensure proper accounting procedures in the future.

The pact settles a civil suit filed last May by Spitzer with backing from the New York State Insurance Department.

The Securities and Exchange Commission, which also worked with Spitzer on the investigation, was to file and settle allegations of accounting fraud with the company simultaneously.

Spitzer spokesman Darren Dopp said the settlement was final.

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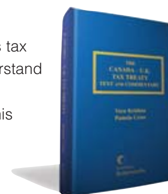

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