Funding long-term goals: Retirement

Business owners face many unique challenges throughout their career. Given the uncertainties of the market, reduced diversification of assets and investments and the need to fund their own retirement, retirement planning is one of those challenges. But it does not have to be.

It is common for business owners to invest most of their assets and earnings in their business, especially during the start-up phase. For retirement, they often rely on selling the business or transferring it to a successor, or winding up the business and selling the assets. However, market uncertainties mean they should not rely on these methods to finance their retirement. By having a retirement contingency plan, business owners may avoid many potential risks.

For many people, the biggest worry about retirement planning is how to fund it. Much of a business owner's net worth is tied up in their business, resulting in a less diversified retirement portfolio. It is important to make an effort to diversify the pool of retirement capital, and there are a number of ways to achieve this.

Personal holding companies

A holding company, separate from the operating company, can hold and protect shares and other investment assets not needed by the operating business. Inter-corporate dividends from the operating company can often be received tax-free by the holding company. However, recent changes to the tax law may re-characterize these distributions as a taxable capital gain.

Registered Retirement Savings Plans

RRSPs allow business owners to invest up to 18% of the "earned income" they received in the previous year, including salaries and bonuses, but excluding dividends. RRSPs are a good way to save for retirement on a tax-deferred basis, but have a maximum contribution limit.

Individual Pension Plans (IPPs)

As an alternative to RRSP contributions, IPPs offer business owners another way to fund their retirement. The contribution limit of an IPP depends on the age of the plan holder, and may provide generous contribution room. Other benefits include creditor protection, a guaranteed income on retirement, and tax-deductible contributions to the plan by the company.

Salary versus dividends

Business owners can choose to receive a salary or to take dividends from the company. A salary creates a tax deduction for the business and allows business owners to benefit from personal income tax deferral by contributing to an RRSP (or IPP). Dividend income does not earn RRSP contribution room and does not create a tax deduction. However, by foregoing a salary or bonus payment, business income can be retained within the corporation, allowing for significant tax deferral and higher after-tax income upon the eventual distribution of a dividend, which is eligible for the dividend tax credit. This option is especially beneficial to business owners who don't require significant funds personally, but need cash flow within the business. On retirement, business owners can continue to receive taxable dividends as a shareholder.

Tax-Free Savings Accounts

TFSAs are a good way to save, invest and withdraw money in a tax-free environment. However, contributions are limited to only $6,000 each year. A TFSA could be a good option as an emergency fund for retirement. Since emergency funds need to be liquid and accessible, the investments held are more likely to be cashable and interest bearing which is the least favourable taxable income, yet it would be acceptable inside the TFSA.

Retirement planning is an important process that business owners must make time for throughout their career. With the variety of funding options, it is best to speak to a BMO financial professional to determine the best retirement planning strategy.

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BMO® Wealth Management

We're here to help.™

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