



Employee Profit Sharing Plans

Peter Merrick

Established under section 144(1) of the Income Tax Act, the EPSP 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 1% 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 do not attract either employer/employee Canada Pension Plan (CPP) or Employment Income (EI) contributions.
- Allows 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.
- 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 of 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 yearend.

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.

What you Need to Know

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

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%

Strategy Employed

Case Study One – A practical application for investing CPP contributions

Imagine the owner of a Canadian Controlled Private Corporation (CCPC) 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 estab-

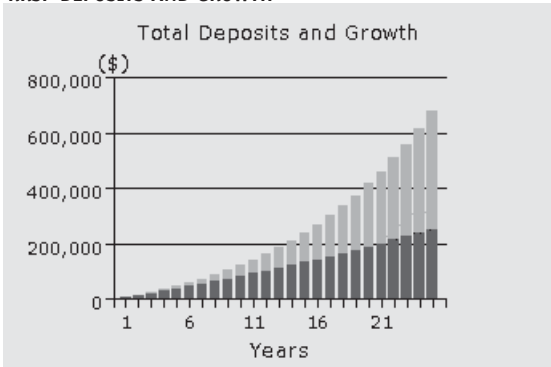
lishing the EPSP the savings will include employer/employee CPP contributions equaling 3,722.40 each or \$7,444.80 combined.

If the business owner decides to invest the \$7,444.80 CPP savings into a balanced portfolio that earned 7.5% annually in an Individual Pension Plan or RRSP, within 10 years he will have accumulated \$15,344.

Now lets take this a step further. Our owner invests both the employer and employee CPP contribution in an RRSP each year in the same balanced portfolio that compounds annually at 7.5%. Assuming his contributions will rise with the average industrial wage rate of 2.5% 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 in his RRSP that would have been earmarked for CPP contributions. The value accumulated within his RRSP before it needed to be commuted into a RRIF at age 70 would be \$679,372 (see below).

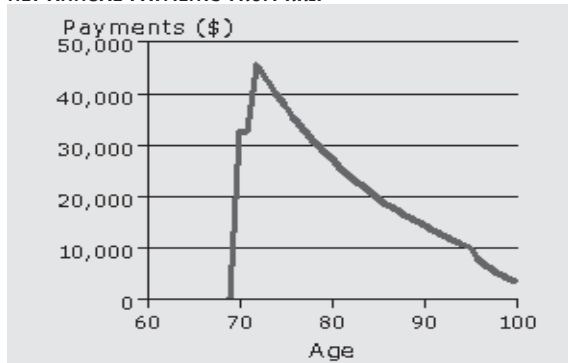
Imagine that this business owner decides to keep the investments mix within his RRIF the same that earns 7.5% annually. From age 70 to 100 our business owner will be able to withdraw a total of \$1,772,590 in RRIF payments and there will be a remaining balance in the plan at age 101 of \$131,977.

RRSP DEPOSITS AND GROWTH



Growth \$425,074
Total Deposits \$254,298

NET ANNUAL PAYMENTS FROM RRIF



Strategy Employed

CASE STUDY TWO – INCOME SPLITTING OPPORTUNITY

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 by Owner \$30,000 (30% Average Tax Rate)
Income Tax Payable by Spouse \$19,125 (25.5% Average Tax Rate)
Total Tax Payable \$49,125

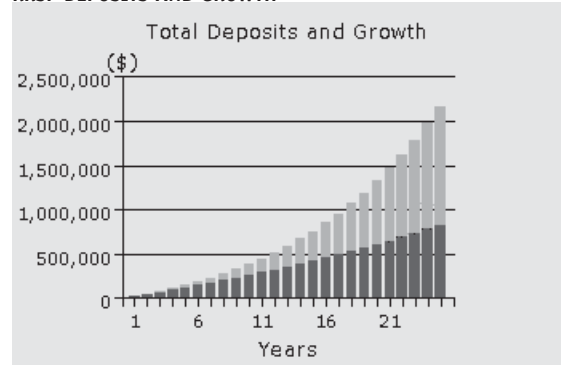
Net Income to Owner \$70,000
Net Income to Spouse \$55,875
Total Net Family Income \$125,875

Note - Difference in net tax payable and net family income with EPSP is \$15,275 in 2006 dollars.
This tax savings could even be greater if the business owner employed his children and they were members of the EPSP as well.

Long-Term Benefit Analysis of Establishing an EPSP

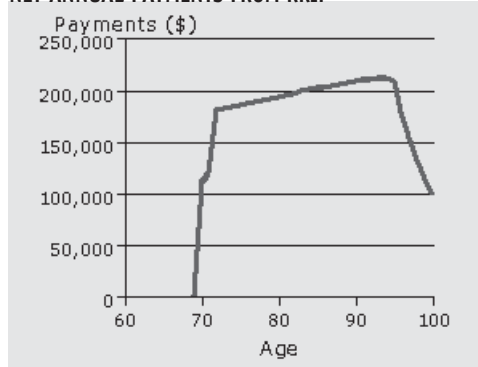
The business owner and his spouse invested their combined savings of taxes and CPP contributions of \$22,719.80 (\$15,275 tax savings + \$7,444.80 CPP contribution savings) into RRSPs. The portfolio compounded annually at 7.5%, assuming their contributions rise with the CPI rate of 3% per year for the 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 (see below).

RRSP DEPOSITS AND GROWTH



Values after 25 yrs
Growth \$1,345,144
Total Deposit \$828,354

NET ANNUAL PAYMENTS FROM RRIF



If he keeps the investments mix within his RRIF the same, i.e. growing at 7.5% annually from age 70 to 100, he will be able to 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.

Peter Merrick, FMA, CFP, FCSI, President, Merrick Wealth Management, a boutique financial planning, employee and executive benefit consulting firm, Toronto, ON (416) 854-1776, peter@merrickwealth.com