Salary
versus
Dividends

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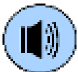

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Dedication

This book is dedicated to all of the business owners in this country who help put in place the business infrastructure that our great country is built upon. Without them, we as a country would be nothing...

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Note from the Author

Why Compensation Planning Is So Important for Business Owners...

Salary vs. Dividends gives you the opportunity to learn how to review your current compensation method and look for compensation breakthroughs that will lead to enhanced control and greater confidence with your wealth accumulation efforts.

The chapters in this book are supported by the companion videos you can watch to see, in greater detail, the charts and graphs in this book explained further. Visit: www.SalaryVsDividends.ca/audiobook to watch these free videos.

I wrote this book and created the companion videos to help Canadian business owners understand that the determination of whether to take a salary or a dividend as your method of compensation has more to do with your desire for long term control than anything else.

As you read, keep in mind that financial planning for business owners is drastically different than financial planning for non-business owners. And, if you as a business owner follow the traditional non-business owner financial planning path, each day you will lose more and more control over your financial future due to the rules surrounding the traditional accumulation plans non-business owners use.

This book is intended to liberate your thinking so that you begin to properly understand what each of the five legal tax-shelters in Canada is truly offering you - in terms of your long term control and to ultimately show you a proven methodology that will allow you to always protect your wealth from the massive, gut wrenching swings so prevalent in today's traditional investment plans.

Helping you gain the insight necessary to make better implementation decisions supported by *your* goals and not the governments is the greatest confidence boost you will ever get.

I'm excited to hear about your compensation breakthroughs.

Chapter 1
Salary vs. Dividends

How often do you hear yourself asking, “Should I take a salary or dividends”.

If you’ve been running a business for more than a year, you may be wondering how to properly and tax efficiently take money out of your business. In light of the recent Liberal government’s new 2016 Growing the Middle Class Budget, the way business owners decide to take money out of their company, either salary or dividends, will dictate the level of control they have over their taxes and personal wealth accumulation from this point forward.

A long term historical study released shows that the long term average combined marginal tax bracket in Canada from 1949 to 1994 was, are you ready for it, 59.04%. That’s an average tax bracket, an average combined marginal tax bracket.

> “...the way business owners decide to take money out of their company will dictate the level of control they have over their taxes and personal wealth accumulation…”

Now the highest combined marginal tax bracket since 1971 was 80% under the first Trudeau government. That was from the Canada Tax Journal.

Considering the top tax bracket was just increased to 53.53%, how you pull money out of your company will make a dramatic difference in your ability to accumulate and keep your wealth. The problem is most business owners don’t have the patience or a system to easily analyze their optimal compensation structure, and they continue to participate in the same wealth accumulation plans

offered to their employees without realizing the time bomb they're setting for themselves.

In Canada there's only five legal tax shelters available to participate in. The Primary Residence Exemption, RRSPs, IPPs, TFSAs and WPPs. And how you choose to receive your compensation from your business will dictate the plans you can and can't use. Therefore setting up the wrong compensation structure will reduce your control and increase the taxes you pay. It's just that simple.

The determination as to how small business owners should take money out of their company is based on four factors, your health, your wealth, your age and your wage.

> "...considering the top tax bracket was just increased to 53.53%, how you pull money out of your company will make a dramatic difference in your ability to accumulate and keep your wealth."

Here's how it works.

If your health is subpar you'll want to focus on salary.

If your health is average or better you'll want to focus on dividends.

If your household RRSP balance is less than $500,000 you'll want to focus on salary.

If it's greater than $500,000 you'll want to focus on dividends.

If you're between the ages of 41 and 71 you'll want to focus on dividends.

If your income is below $90,563 you'll want to focus on salary, if you're income is greater than $90,563 or will be for the majority of your business life you'll want to focus on dividends.

Now, pay attention because this is critical.

If you love being a business owner and this is your intention for the rest of your life, **you'll want to focus exclusively on paying yourself via dividends.**

Part of why this works so well is that the essence of the analysis is based on your desire for control. The more control you want the more you should focus on dividends. What's more interesting is that the math behind the psychology of control supports the findings.

The big thing I want to talk about today is the comparison between salary versus dividends and reveal to you what the tax man wishes you never knew about.

"The more control you want, the more you should focus on dividends."

A lot of this information has come from a lot of research and development and analysis from financial plans that have been created for business owners.

The big question that most business owners ask is:

"Is my current compensation structure right?"

They've been building their business for many years. They've been taking money out of their company to pay their bills but have been doing so without any strategy behind how they've been receiving their compensation. They've just never taken the time to determine the best method to pull money out of their company. There has never been any structured methodology that truly supports their wealth accumulation efforts.

Financial planning for business owners is different. If a business owner follows the “typical” approach to financial planning, long term regrets will set in.

What I want to do is take a look at what typical financial planning tells us because that’s going to dictate how a lot of business owners take money out of their company.

Typical financial planning has always told us to:

1. invest early in the stock market,
2. maximize an RRSP,
3. buy a car
4. get married
5. start an emergency fund
6. buy a home
7. have kids
8. educate your kids
9. then retire comfortably.

Now the reality is as a business owner your reality looks a lot more like this…

1. Start a business.
2. Work like a dog.
3. Get married.
4. Work like a dog.
5. Stress about money.
6. Work like a dog.
7. Have kids.
8. Stress more about money.
9. Work more.
10. Feel more guilty for working more.
11. Try to be the best parent or spouse you can be.
12. While working like a dog.
13. Experience business growth.
14. Begin to see some financial rewards.
15. Start to invest in RRSPs regularly to catch up for lost time.

16. Realize your kids are growing up fast, which hurts in your gut.
17. Take more trips with your family to grab more family time.
18. Begin to resent the tax man more and more because of the level of tax you have to pay on your income. Income that was never there before, but is there now because of all of your hard work.
19. The problem is you're also seeing how much is going out to taxes.
20. After the last stock market correction, "buy and hold", that whole concept doesn't feel like the best solution anymore.
21. Investing becomes something that seems to stress you out more and more.
22. Willingly settle for low returns from safe investments to help eliminate the investment stress.
23. You feel like you're never aware of good quality investment opportunities, it always seems to be something that other people seem to be made aware of.
24. You wonder how anyone ever makes it in this world with all of the financial challenges that you know you're facing.
25. You're always wondering if what you're doing is right.
26. Should you be investing in an RRSP?
27. Should you have a holding company?
28. Should you buy a TFSA?
29. Is a salary or dividend a better compensation structure?

Here is what you need to know.

As a business owner you need to know the realities of what salary versus dividends mean. The realities of RRSPs and the realities of the cost of cash.

Knowing and understanding these three concepts will actually help dictate your strategy and your compensation plan going forward.

It does take a little bit of time and so what I want to do with this content is really dive into the truth behind a lot of these concepts. Knowing the truth behind these core concepts will provide you

with clarity and confidence that what you're doing is the right thing for your future. You will know very clearly what it is you need to be doing once you've understood these concepts a little bit better.

I definitely want you to watch or listen to **The Truth Behind Salary vs. Dividends**, **The Truth Behind RRSPs**, and **The Stealth Killer of a Business Owners Financial Future**.

Watch these three videos and I guarantee you'll have so much more clarity on what your best solution is and how to formulate your compensation structure… Watch the video's, you'll be glad you did.

You'll find these videos at audiobook.salaryvsdividends.ca.

Chapter 2

The Salary Fable

As a business owner the one thing you're really looking to determine is what your best compensation method is. Do you take a salary? Do you take dividends? Do you take both?

There's a difference between what happens to your wealth accumulation plan depending on the decision you choose.

Let's talk about why there's a difference between salary versus dividends and what this really represents in the world of taxation.

The government looks at the different types of income you can receive with an eye to "integration".

When you take a salary, this becomes an expense to the company, which reduces the taxable income of the company by transferring the income to you through your salary.

Dividends on the other hand are looked at differently. Dividends are available to the shareholders of the company (you, the business owner) as company profits that can be paid out. The extra earnings above expenses a company makes (Retained Earnings) are available to all shareholders. When you elect to pay a dividend, you are paying company profits out to the shareholders.

Currently, any money left in the business (retained earnings) are taxed at a special, lower rate to encourage the retention of profits in the company to then be reinvested in the company to help grow the company and ideally, employ more people (which is good for the country).

But, when dividends are paid, there is a refund of the tax paid by the company to the company on money that is paid out to

shareholders as a dividend. The shareholders will then pay personal tax at their marginal tax bracket.

Basically, integration exists between the two methods because if you calculate the tax rate paid on a salary income versus the tax paid corporately and personally on dividends paid, they are virtually the same.

Every year there seems to be a mathematical calculation that tilts the scale one way or the other, but the net result is the differential between salary versus dividends can often times be so miniscule that it doesn't really make sense to base a long term financial planning decision on that because it could change in a heartbeat.

Recent corporate tax changes are clearly showing that the government is focused on attacking small businesses through their power of taxation.

> "The government's really obsessed with obtaining… perfect integration between receiving a salary or a dividend."

You can go online and find a calculator or videos that show the calculations, step by step and the difference is miniscule between the two. So I'm not going to spend too much time on that.

What I'm going to spend time on are the decision making components that really make a difference to your long term planning. And the most important component to deciding whether you take a salary or a dividend is control.

How much control do you want over your long term financial affairs? What we're going to do is we're going to take a look at a practical example of this and we're going to show you the before and after, so to speak, so you can see the difference between the

two, but more importantly you can see the difference in control that you have.

Let's look at a couple, Fred and Wilma Flintstone. Everybody knows Fred and Wilma, we're going to take a look at their affairs.

Their compensation puts them in the top tax bracket. Fred's 44, Wilma is 48 years old, they've got two children, 12 and 13, they own a vacation property. They currently have about $800,000 in RRSPs, $400,000 in each of their plans. They're aiming for a financial freedom date of Fred's age 65.

I stress the term "financial freedom". I didn't say retirement date because they're business owners and business owners are a different breed who never really ever retire.

Business owners tend not to have a retirement date. They tend to stay engaged in life, for life. They love doing what they're doing, that's why they're doing it. But they do have a point at which they want to know that they're only working in their business, not because they have to, but because they want to. This is known as their *financial freedom date*.

Fred and Wilma's financial freedom date is when Fred is 65 and they're personally saving about $50,000 a year, $25,000 each, into an RRSP.

> "Business owners tend to not have a retirement date, they want to stay engaged in life, for life."

That's the scenario we're going to take a look at.

And so what we're going to do is take a look at the results of that. Now what they're looking for is about $90,000 a year from an after tax standpoint, adjusted for inflation.

They’re saying, “Look, if I could have financial freedom knowing I had $90,000 a year coming in after tax, that’s pretty much spending money, adjusted for inflation, when I’m 65 then I know that’s going to make me feel financially free. That’s going to give me confidence”. And so, forecasting that forward what we’re seeing is that $90,000 in future dollars, so that’s actually 20 years away right now, is actually $162,500 in future income requirements.

That’s a net after tax future income of about $162,500 that they need to generate in order to attain their financial freedom goals. That income level will be adjusted for inflation going forward.

The inflation rate I’m going to be using in this example is going to be 3%, which again is high but I tend to like to be on the conservative side when I make these analysis. So we’re looking at $162,500 future value cash flow starting at age 65, and then adjusting for inflation going forward.

Now, take a look at the fact that they’ve accumulated $800,000 in RRSPs and that’s really all of their liquid capital, that’s what they’re using for funding their retirement goals. Going forward what I’m looking at is “will they be able to meet their lifestyle goals”? Will they be able to accomplish that? And so we just take a look at some forecasted cash flow calculations to determine if this is doable.

Now where is that future cash flow going to come from?

Well it’s going to come initially from government benefits, retirement investment accounts and a small portion from a dividend from their company.

I forgot to mention they do have about $150,000 in corporate savings that they have in the company right now, and we’re just assuming that that’s going to simply grow at a 5% growth rate.

Assuming it's a decent diversified portfolio, earning a 5% growth rate should be doable.

And so our calculations show they're able to meet their cash flow requirements in any given year. However at around age 71 when their RRSPs need to convert to a RRIF, guess what happens?

Their taxable cash flow suddenly spikes. There is an amount that's being forced out of their RRSP that is in excess of what they need due to the minimum withdrawal amount calculated by the government.

That's a big issue because they are being forced into a higher and higher tax bracket as the cash flow they don't need for lifestyle purposes is forced out of their plans. All because of the rules surrounding registered investments. So we're going to talk about this a little bit.

All my calculations are based on them living beyond their life expectancy to their age 90. So you can see that we're really planning with pretty conservative assumptions. A 3% inflation rate, a 5% growth rate and they're living to age 90.

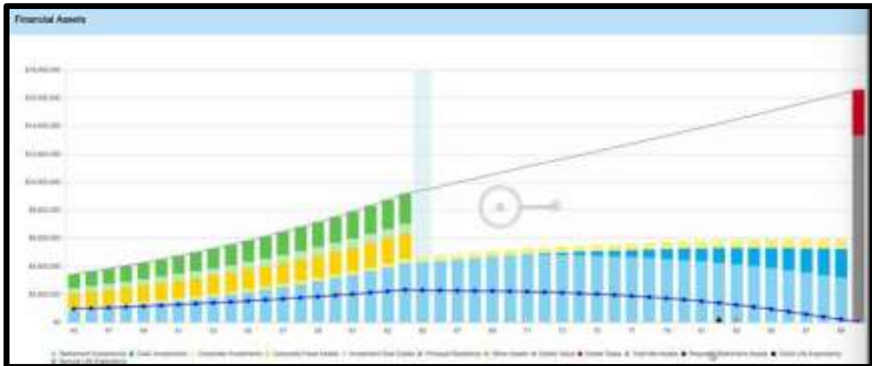
Now if we take a look at their forecasted net worth in the following graph, we're looking at a similar timeframe. The only difference is now we're looking at the assets that they have and what their total net worth is made up of over time.

You can see that at age 65, their net worth includes the value of their home, which is this green bar. This illustrates what the forecasted value of their home is expected to be over time. I've only increased the value of their home by 3% annually, equallying the rate of inflation.

I have made the same assumption with the vacation property they have. We're not assuming they sell any real estate at any point in this analysis.

I'm assuming that their business only grows at the rate of inflation which again is a conservative assumption.

But you can see that all of a sudden when they retire, there's distance between their total net worth (the grey line) and their liquid net worth (the yellow and blue bars). In other words, that gap represent the portion of their net worth that they're not going to be using to generate cash flow during their retirement years.



In other words, they're not going to be using their home, they're not going to be using their vacation property and they're not going to be using the value of the equity in their business to generate retirement cash flow.

They may have some cash flow from their business but from age 65 onward, we will not be assuming any further cashflow will continue from the business. In other words, once they retire, they'll be drawing down on their personal assets and retaining all surplus cash flow generated by the business, in the business.

For this plan, I want to just use their liquid wealth to generate cash flow.

As time progresses, their net worth is continually rising as due to the conservative growth rate assumptions just discussed. This is a classic representation of a lot of business owner clients in the sense that their financial affairs look pretty solvent.

However, the one thing we do know is that as you accumulate wealth, things don't get less complicated, they get more so.

There's a very important calculation that must be done for all business owners. It is called, the "required retirement assets" line.

This line represents the portion of one's net worth in any given year that is needed in liquid investments for financial freedom goals to be met. You can see on the graph that we've got a very interesting blue line showing up that actually gives us insight into their planning needs.

This critical calculation is telling us that a portion of their liquid assets are considered surplus assets and a portion of their liquid assets are considered required assets.

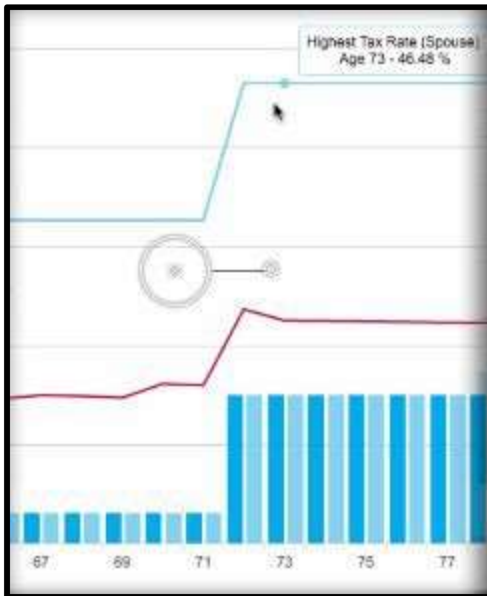
The required assets are any assets below the blue line, surplus assets are any assets above the blue line.

That means that anything below the blue line is required in order to meet their annual cash flow requirements for the reamining years in the analysis. Anything above the blue line is identified as funds that are probably not going to be spent, by them, during their lifetime.

It's these liquid assets above the blue line that will probably go to the next generation. It's also nice to know that these assets are there just in case there's a financial crisis that needs to be dealt with or a medical issue that needs to be dealt with. They've got extra surplus cash that they can tap into.

Now all of this is giving us a lot of information as to whether or not it's good for us to be taking a salary or a dividend out of our company because the difference here is that in this scenario what we're seeing is that by taking a salary, and this is a salary example, by taking a salary it's allowing us to maximize our RRSP contribution.

What we did see in the cash flow section is that by maximizing our RRSP, our cash flow going forward actually pushes us into a higher and higher tax bracket during retirement. Just take a look at what happens to the tax bracket, as soon as they to age 71. There's a spike that takes place and this spike moves us from a 32% tax bracket right up to a 46% tax bracket, and it leaves us there for the rest of our life. ***It basically gives us a life sentence at this higher tax bracket.***



This is a very key component to determining whether it makes sense to take salary or dividends out of your company because in this example where someone is following the traditional approach... taking a salary, paying tax on that salary, putting that excess money that they're taking out into their RRSP and maximizing their RRSP, this is actually causing a tax problem during retirement.

I bring this to your attention because ***I don't know any business owner client who as a result of following this path is enjoying their RRSP during their financial freedom years.*** They're actually regretting ever having contributed so much to is because of the life sentence they end up receiving at that top income tax bracket at exactly the wrong time in their lives.

That's an important point to make because control is the big issue here. Is this type of planning giving you more or less control? They're actually ending up with less control because the government is forcing them to take money out of their plans that

they don't need. Most business owners are not stopping work at their financial freedom point. They're usually engaged in something during those years and that something usually generates income which leads to profits.

It's an important analysis because there will be other income that's available to them from a cash flow standpoint, so wouldn't it be nice to be able to just leave this excess cash flow that we don't need for our lifestyle alone - in the tax-sheltered environment?

Following this "typical" approach of maximizing an RRSP actually causes more future tax problems than it solves in the short term.

You can also see that from age 72 onwards we have tax credit clawbacks of Old Age Security at the maximum rate. These clawbacks are just another form of taxation on those who have taken their financial wellbeing seriously and put money aside for their future. In this case, planning has led to higher penalties.

It's not a great place to be and this is really what the typical financial planning books promote. I'm just not convinced maximizing your RRSP is always the best solution… especially for business owners.

At higher income levels and at higher wealth accumulation levels, maximizing your RRSP is actually causing future problems.

The other thing I want to point out is that if we take a look at the financial assets at age 90, the deemed disposition tax equates to approximately $3.2 million in taxes due.

I did mention that there's a surplus of cash. Knowing that there's a surplus available - the question often times is, "What could I have for a retirement income".

The one thing that I know is that people have no sense what they actually need to fund their retirement income lifestyle.

It's very difficult to forecast 20-30 years away from now how much cashflow you're going to need when you retire. But when I tell people how much cashflow they're on track to receive at various points in the future, the conversation suddenly changes.

> "As business owners, we shouldn't take risks with profits we generate from our business... that's foolish!"

Everyone will have an opinion on their "attainable cashflow" because the number that I calculate is either going to be higher than they thought, lower than they thought or right around what they thought. The point is they're going have an opinion and that opinion stems a much better financial conversation.

We also know from the planning that we do that Fred and Wilma's required rate of return, the return that they need to make on their investments going forward for everything to work out, is only 2.42%. That's important because now we know that this client does not need to be a hero with their investment portfolio. They don't have to be very aggressive with their wealth accumulation plan and take undue risk.

As business owners we take a lot of risk (albeit a calculated one) to go into business for ourselves. And, quite honestly, the greatest return on investment we could ever make would be to invest back into our business.

But, what business owners do to create their wealth (concentrate all of the investment in one, high risk security - their business) should not be duplicated when they remove money from their company for retirement investing.

We shouldn't attract undue risk on the profits we pull out of the business. Taking undue risk on the profits that we already took a risk to generate is foolish. We shouldn't take the risk twice. This results in more than twice the risk.

Calculating the "required rate of return" (the minimum return required for the plan results to have a 100% success rate) helps us to appreciate that we don't need to be a hero with the investment portfolio.

This is the first step in developing a sound investment plan.

Following a financial planning process that allows us to stress test the plan a little bit helps us to determine how to increase the plans probability of success. Without this, people tend to gravitate to trying to earn the highest rate of return on their investments, which actually reduces the plans probability of success because of the amount of undue risk that is attracted to this approach.

> "...why set yourself up to be forced to take out [and pay tax on] money from your retirement plans at a time when you might not need the money."

Also, another form of taxation rears its ugly head. OAS clawback (a forced reduction in government benefits due to the higher taxable income) begins to erode our investment base because we now have to take more income out of our existing plans to cover this added layer of tax.

Which, brings up another issue… the trajectory of our tax rates allows us to see that one of the only remaining revenue leavers the government has left to pull on is the income tax rates.

Ask yourself this question… Do you feel income tax rates are going to be lower, the same or higher in the future? I would suggest that since our governments are not capable of reducing the size of government to help run more financially responsibly, that they will begin to increase the income tax rates to help fund their ever increasing expenses. This, in no way, is good for the successful business owner.

The net result is that the number we are looking at for Fred and Wilma in this example are probably going to get worse due to the ever increasing threat of increasing taxes.

When making your decision to take a salary or a dividend, or both, weigh heavily the negative effects of higher future taxation.

Chapter 3
Take back control with Dividends

Now when we take a look at the plan results when we follow a dividend only strategy, we're seeing some interesting results.

Professionals who have put time into studying this topic all agree that when a business owner takes their compensation out of their business they should only take out an amount that is needed to cover their personal lifestyle expenses. No added funds are to be taken out to fund investments in any way.

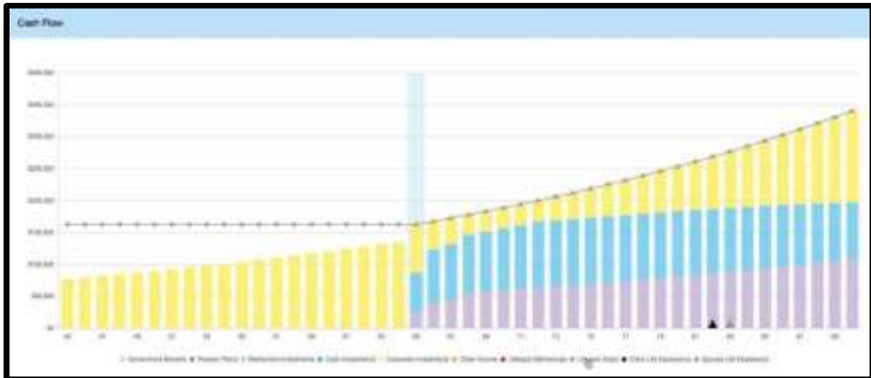
In this example, the money that Fred and Wilma need was basically all of the money they were taking out less the money they were putting into an RRSP.

When we then convert their compensation plan to a dividend only plan, the $50,000 they were taking out to put into a RRSP is no longer needed to be taken out of their company and can then be retained and invested within the company.

Leave that money in the corporation, ideally in a holding company through a family trust, for better asset protection reasons. The point being made here is that the money is now being invested in a corporate environment as opposed to a personal one. As a result, personal taxable income is minimized and all retained earnings are being invested in the company's name.

Remember that the overall tax on the salary or the combined corporate tax and personal dividend tax on dividends illustrates that there is virtually perfect integration between those two form of income. But, when you convert your compensation to a dividend only structure, you no longer have to pay personal and corporate Canada Pension Plan contributions. And, since the CPP rates are expected to increase, you are avoiding this cost which increases your company's retained earnings.

When we take a look at the net result, the company needs to earn less money to get to the same result or, the company is left with greater surplus when earning the same amount of money. The wealth accumulation is now done in a separate company (I call this company a Retirement Company or RetirementCo).



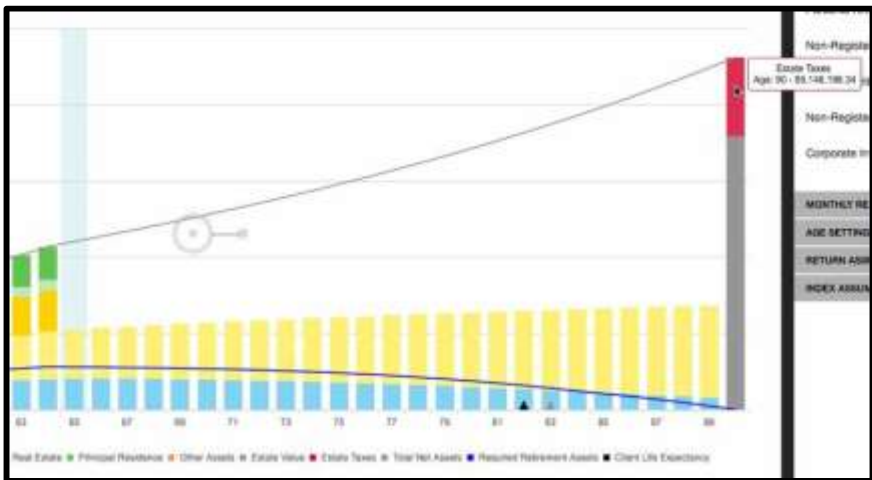
In the example we are working through, I am not suggesting that they move their existing funds that are in the RRSP out of the plan and into the company investments, that might attract some early, undue taxation.

They came to us with $800,000 in their RRSPs. So we haven't done anything with that, other than find the best investment solution for those assets. Up to this point, Fred and Wilma have generated some CPP benefit. But, going forward, since they are no longer contributing to the CPP, we're going to reduce the ultimate benefit received from CPP during retirement.

Notice in the chart above that their taxable income stream has smoothed as every year they're able to meet their cash flow objectives through planned withdrawals. There are some strategies that I won't go into here but know that there are other options that will allow them to take the money out of the corporation in a much more tax efficient manner to a point of actually taking it with zero taxation.

The analysis shown here assumes they simply take the money they need for lifestyle purposes out as a dividend and pay the appropriate amount of personal tax on it.

From a financial asset standpoint you can see here that we still have a lot of similarities however a lot of the balances that we're seeing are corporate assets as opposed to personal. We're building much more wealth inside a corporate environment but because you're the owner of the corporation then it's simply a different structure for your net worth.



You can see here that the estate taxes have gone way up. That's a good thing. I've always said to people that I'm happy to pay the highest amount of tax knowing I'm paying those taxes on the least amount of my wealth. That simply means that we've accumulated more wealth for this client because of the way we've structured their affairs, and as a result, on death there is going to be a higher tax bill as a result.

From an income tax standpoint we now don't see a big spike in tax bracket at age 72 when they begin to receive their minimum payments as a result of converting from an RRSP to a RRIF. The reason is that we haven't overfunded a plan that ultimately forces money out at a point in the future when we don't need it. As a result, our tax bracket has dropped considerably. We're down to

the 33% marginal tax bracket as opposed to being up in the 47% tax bracket. And, going forward, the average tax rate starts to slide down a little bit also.

The big benefit we're seeing is that we're giving ourselves more control in the future over how and when we utilize the money. If we need it we can take it out, but if we don't need it we can let it accumulate. Which is the complete opposite of a government sponsored plan like an RRSP.

From a retirement option standpoint, as a result of accumulating more wealth our attainable annual cash flow during retirement has increased to $136,000 from $129,000.

Our required rate of return has reduced which means we don't need to be a hero with our investments. We can be more conservative if we want to which will allow us to increase our financial plans probability of success.

Our goal then is to acquire *more control.* It's very clear that if we focus too much on government sponsored plans, we're giving up future control of our cash flow.

Chapter 4
The RRSP Trap

We're going to start off with a bit of an example here.

This content is put together for business owners to gain clarity on the truth behind the wealth accumulation plans that are available to them during their lifetime.

I'm going to ask you a question. I want to see if you would take this deal.

You and I are going to start a business together. Here are the terms of the deal:

1. You're going to put up the capital.
2. You're going to make all the decisions.
3. You're going to take all the risk.
4. You're going to lose the use of any money you put in for any other purpose while it's in the business.
5. You're not going to be able to access any of the money in the business unless you pay me first.
6. You can then sell the business any time you want but when you sell all or a part of the business, at that point I will then tell you how much of the business I own.

Would you take this deal? Would you go into business with me under those terms?

I haven't had anybody say yes they would.

So let's take a look then at what an RRSP is asking us to do.

1. You put up the capital.
2. You make the investments.
3. You're going to make all the decisions.
4. You're going to have full flexibility and control as to what investments you choose.

5. You're going to take all the risk - all the future values in that plan are going to be 100% variable.
6. You can't use the money in the plan for any other purpose - it's locked away, it's sort of put in "jail" and that's one of the frustrations we have is that when the money goes in we kind of feel it's gone forever.
7. You're not going to be able to access any of that money in the plan without paying CRA first.
8. At age 71 you're forced to begin selling some of the plan whether we need the money or not and paying tax on the money. If we take a look at our tax history, we know that tax rates are rising and have historically been higher than they are now.

So the problem is that when we are forced to take the money out of the RRSP, we don't really know what tax rates are going to be. But we do have a lot of information to support the idea that tax rates will probably be higher in the future than they are today.

The previous example I gave you was more of a philosophical idea that you would probably never go into business with somebody who offered you a business relationship under those terms. Well, in this case, recognize that the RRSP is very similar to those terms.

In this example we're going to use somebody who's currently aged 45 and we're going to analyze their situation to age 71 because 71 is the point at which RRSPs have to be converted to a RRIF. Which means it will be added to their income from age 72 onward.

Let's assume that they have $500,000 in their plan today, both spouses will contribute $25,000 annually for 20 years and the plan will earn an average of 6% going forward.

To continue to generate RRSP contribution room, a business owner must take their base compensation out in the form of a salary to help build the next years contribution room.

By age 71, there will have been roughly $1,550,000 worth of contributions.

Earning an average annual return of 6% would bring the account balance by age 71 to $5,417,887.

What was the reason we were told to use an RRSP for our wealth accumulation needs?

Tax Deferral.

We’re told that not only are we going to be able to earn a return on our own money but we can also earn a return on the government’s money (the deferral) while it’s in the plan.

Really then the tax deferral growth is free growth as it’s money earned on someone else’s money. Incorporating this into the calculation shows that our real return on our money plus the return earned on the government’s money is 8.89%. So our net contributions are actually $818,000, the difference between the two is simply the amount of money that we haven’t paid to the government in tax yet and that’s the deferral, that’s the amount that we’re making on that. So the effective rate for that is 8.89%.

It means that if we’re earning 6% on our contributions as well as earning a return on the government’s money, we’re borrowing their money to invest. This is known as leverage (using other people’s money for your own personal benefit). Therefore, our real return is 8.89% on our contributions.

This is usually where the analysis stops because it looks almost too good to be true.

The problem is the conversation hasn’t been taken far enough. The conversation stops there because that’s all anybody needs in order to encourage somebody to make the contribution. This conversation is usually had with someone who is selling RRSPs.

I want to take it to the next level and give you the math that goes on beyond the accumulation phase.

The pile of money created in this example is approximately $5,400,000. It sounds like a lot of money. And it is. It's just not all ours.

None of the money has been taxed yet. But it will be when we begin taking the money out of the plan.

If we begin taking money out from age 65 to 90 so that it's taken in equal instalments annually, we can take $261,000 out annually.

Then, we have to pay tax on this money. Generally, this money is on top of other income we may be receiving which helps to push us into the top marginal tax bracket. If we tax that money appropriately, the real rate of return after-tax of the benefit of the net amount that we receive in our pocket is actually 5.61%.

It's actually a little bit less than the 6% we thought we were earning and well below the 8.89% we were told we were earning from the deferral benefit.

We also haven't taken into account the fact that to earn the 6% return, we needed to hire someone to help us with this. The average mutual fund fee in Canada is 2.5%.

If we now account for this, our annual withdrawal rate is now reduced to $138,000 because of the added layer of management fees we had to pay along the way to manage the plan.

Our real rate of return has now dropped to 2.97%. So you tell me, we took a risk to earn a 6% return, made sure that the taxes and management fees were paid and now we're netting the 2.97%. Are we still loving RRSPs?

Our analysis isn't over yet.

Here’s the one thing that nobody talks about.

Let me ask you this…

When you received your tax refund from the government that you generated by investing your money into an RRSP, what did you do with it?

If you’re like the majority of Canadians who receive tax refunds, you deposited it into your bank account and those funds quickly became part of the funds you use to cover your lifestyle costs.

Which means that you didn’t even get the benefit of the tax deferral because the deferral was never put back into the plan. It was spent.

If we then take the tax deferral out of the equation because we didn’t take the refund and put it back into our plan, our real rate of return is now 0.5%.

Half a percent is really not something that I feel is a great rate of return especially when we were investing in a solution, that we were trying to earn a 6% rate of return from.

The reality is that at the end of the day it just doesn’t seem like there’s a lot of reward for the risk we were taking.

Remember the analysis at the beginning of this chapter where I asked you to go into business with me? I made you put up all the capital, take all the risk, lose use of the money while it’s in the business and when you take it out for your own needs, at that point you’re going to start paying me and I will then tell you how much of the business I own.

This is no different than an RRSP.

We don’t know what that tax rates are going to be in the future so we have no idea how much of the pile of cash we accumulated is going to be owned by the government.

I’m not necessarily saying RRSPs are completely bad. I’m just saying that they don’t necessarily support the needs of the typical successful business owner.

Chapter 5

The stealth killer to every business owner's financial plan...

There is a stealth killer to every business owner's financial plan. It's something so heinous that until it's revealed to you, you don't even know of its existence and how it is robbing you of your ability to build the wealth you deserve.

It's not taxes, (although we know that paying more than your fair share will also kill your financial plan).

It's not inflation, (although without paying attention to the rising cost of things, you could quickly run out of money at the worst possible time in your life).

It's something even more evil. Something so evil that once you see how much you are being robbed by this silent killer you'll want to arm yourself to protect against it at all cost.

Let's look at an example so you can see how this evil silent killer is hiding in plain sight.

In this example, we're going to go through the lifecycle of saving for and buying cars. Something we all need to do so it's something we all can understand. I'm not concerned about what kind of cars you like to purchase or how much you comfortable spending on a car.

I'm more concerned with revealing to you the half-truth we are fed in terms of what the best way of buying a car is.

There are only three ways we can acquire a car these days.

1. First, we can Lease a car.
2. Second, we can Finance a car.

3. Third, we can pay cash for a car.

Leasing a car means we in essence rent the car for five years and then give it back after paying a lease interest rate on the car. We end up owning nothing so we have nothing to show for our acquisition other than five years of rental payments that included a certain interest rate that was built in to the payment. The payment is usually lower but you do not build equity in your car.

Financing allows us to borrow the money from a finance company, buy the car and then pay back the borrowing over a term (in this case we'll use five years) at interest. When you are done paying back the debt, you have not only bought the car but paid a boat load of interest to the finance company in return for them lending you the money.

Saving up and buying the car for cash is mathematically considered the cheapest option for buying a car because you never pay a finance or lease company any interest. You simply save up and then use your own money to buy your car. What could be simpler?

Let's then analyze the cheapest option (saving up and paying cash for your car) to reveal the silent killer lurking in the bushes. Understand that the silent killer lurks in the bushes of each scenario above but the one we'll analyze is the scenario most people think is the cheapest option - save up and buy your car for cash.

This is just going to be a simple exercise in mathematics.

Let's assume that we want to buy our first car worth $50,000 in five years. Then every five years after that we'll take whatever we can get for a trade in value on our current car to buy and upgrade our next car. We will still need to have another $50,000 to put toward the next purchase. Every five years we'll then need $50,000.

Let’s assume that we start off with an account that has nothing in it and we’re going to start saving $10,000 a year in anticipation of purchasing our next car for $50,000 in five years. This means we’re saving $10,000 a year, a total of $50,000 in five years.

We’re not just going to put that money into a shoebox under our bed, we’re going to earn 5% on that money every year and we’re going to look at this analysis over a 30 year time period.

Now if we did put aside $10,000 per year on an ongoing basis for 30 years and didn’t do anything with that money other than let it grow we would have a value in 30 years of $697,608. That’s $697,608 of real money.

But we want to buy cars.

So let’s go ahead start purchasing those six cars over the 30 year period. Purchase the first car in five years, and then we’re going to purchase a car every five years thereafter over that timeframe.

Over the 30 years we have needed $300,000 of our own money to put toward the purchase of those six cars (6 x $50,000).

Now as I said before if we didn’t do anything with the money and we just put it into our investment account earning 5%, we would have an account worth $697,000.

But instead of letting the account just grow, we decided to take $300,000 out over that time period and purchase our cars.

Simple math then says if we did this, we should have $397,000 left in our account at the end of 30 years. But, when we look at the balance of our account 30 years later we see that the balance in the account is only $66,361.

Does that really mean that it cost us $631,247 to purchase $300,000 worth of cars? Yes it does.

How on earth did that happen?

Pay attention to what's taking place here. When we follow the financial guru's message that says the cheapest way to buy things is for cash because there is no sense in paying useless interest to someone else when you don't have to, you're getting killed by the silent killer.

The problem is that people aren't recognizing that by taking that $50,000 out every five years to avoid paying interest, we're giving up our right to receive interest or the growth on that $50,000.

So the problem is that if we keep taking that money out and use our cash, yes we're avoiding an interest payment but we're not avoiding an interest cost because the interest cost in this example was actually the foregone cost or the foregone interest that we should have earned if we had left the money in the account earning 5%. As a result, buying $300,000 worth of cars cost us $331,247 to acquire $300,000 worth of automobiles.

Why would we then pay $631,247 for $300,000 worth of vehicles?

You finance everything you buy. You either pay up interest or your pass up interest. This phenomena is called "Opportunity Cost" and is completely avoidable.

Current Value of Assets: 0
Annual Savings: 10,000.00
Annual Savings Increase (%): 0.00%
Net ROR on Savings (%): 5.00%
Number of Years: 30
Year of 1st Purchase: 5

Auto Purchase Frequency: 5
Actual Purchase Price: 50,000.00
Ann. Auto Price Increase (%):
Sales Tax Rate (%):
Ann. Auto Insurance Premium:
Ann. Insurance Increase (%):

Title | Clear | NEW

Future Asset Val. WITHOUT Autos: 667,808
Cumulative Auto Costs: [illegible]
Actual Asset Val. WITH Auto Costs: 66,381
True Cost Of Automobiles: [illegible]

Yr	Annual Savings	EOY Asset Value NO Auto Costs	Automobile Purchase	Sales Tax	Cumulative Auto Costs	EOY Asset Value WITH Auto Costs	Loss of Future Asset Value
1	10,000	10,500				10,500	
2	10,000	21,525				21,525	
3	10,000	33,101				33,101	
4	10,000	45,256				45,256	
5	10,000	58,019	(50,000)		(50,000)	5,518	(52,500)
6	10,000	71,420			(50,000)	16,295	(55,125)
7	10,000	85,491			(50,000)	27,610	(57,881)
8	10,000	100,266			(50,000)	39,490	(60,775)
9	10,000	115,779			(50,000)	51,965	(63,814)
10	10,000	132,068	(50,000)		(100,000)	12,563	(119,505)
11	10,000	149,171			(100,000)	23,691	(125,480)
12	10,000	167,130			(100,000)	35,376	(131,754)
13	10,000	185,986			(100,000)	47,645	(138,342)
14	10,000	205,786			(100,000)	60,527	(145,259)
15	10,000	226,575	(50,000)		(150,000)	21,553	(205,022)
16	10,000	248,404			(150,000)	33,131	(215,273)
17	10,000	271,324			(150,000)	45,287	(226,036)
18	10,000	295,390			(150,000)	58,052	(237,338)
19	10,000	320,660			(150,000)	71,454	(249,205)
20	10,000	347,193	(50,000)		(200,000)	33,027	(314,165)
21	10,000	375,052			(200,000)	45,178	(329,874)
22	10,000	404,305			(200,000)	57,937	(346,367)
23	10,000	435,020			(200,000)	71,334	(363,686)

Here’s What To Do Next...

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