

RETIREMENT COMPENSATION ARRANGEMENTS

A Retirement Compensation Arrangement (“RCA”) can be a valuable planning tool that can effectively provide solutions to retirement planning and, in some circumstances, tax reduction.

The key to successfully using RCAs is to understand how they work and how they can most effectively fit into an estate plan.

WHAT IS AN RCA?

An RCA is a plan or arrangement under which contributions are made:

- ❖ by an employer, or
- ❖ by a former employer, or
- ❖ by a person with whom the employer or former employer does not deal at arm’s length

to another person in connection with benefits that are to be received by any person,

- ❖ on, or
- ❖ after, or
- ❖ in contemplation of

any substantial change in the services rendered by an employee, the retirement of an employee or the loss of an office of an employee.

If a plan or arrangement meets the definition of any variety of other plans set forth in the *Income Tax Act* such as a registered pension plan, insurance policy, disability or income maintenance policy, deferred profit sharing plan, employee profit sharing plan, RRSP, employee trust, group sickness or accident insurance plan, vacation pay trust, salary deferral arrangement, plan or arrangement for deferring the salary or wages of a professional athlete, plan or arrangement (other than an athlete’s plan) that is maintained primarily for the benefit of non-residents in respect of services rendered outside Canada, or a plan set forth in

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the regulations to the *Income Tax Act*, then the plan is precluded from being treated as an RCA.

RCAs are generally established as a trust. However, it is not necessary for a plan or arrangement to meet the legal requirements of a trust.

The person who administers the plan and holds the contributions is referred to as the “custodian”. There are no limitations on who can be a custodian.

HOW CAN RCAs BE USED?

RCAs are a useful means of providing for the retirement of a key employee, including the owner-manager of a business. RCAs can provide tax benefits where the employee expects to be taxed at lower marginal rates after retirement.

Note that there must be an employer-employee relationship between the corporation and the beneficiary of an RCA for an arrangement to qualify as an RCA. RCAs are therefore typically restricted to operating corporations as opposed to holding corporations. Both retirement benefits provided by the plan and the amount of contributions made to fund the benefits are subject to a reasonableness test. For this purpose, the tax authorities take the view that retirement benefits should be reasonable in relation to the employee's length of service and compensation history, taking into account, for example, the level of retirement benefits generally paid by other companies in the same or related businesses to employees in similar positions. It is typically not possible to justify efficient funding of an RCA by a holding corporation.

An RCA is also useful in an arm's length employment situation to guarantee the funding of a promised income stream from the former employer.

HOW IS AN RCA ESTABLISHED?

An RCA is established when the employer (or other eligible contributor) contributes an amount to the custodian under the terms of the plan or arrangement. The custodian must obtain an RCA account number as well as a separate custodian account number from the Canada Revenue Agency (“CRA”) for the plan.

There are certain components which the CRA regards as essential to the characterization of a plan as an RCA. One of the more important components is the maximum funding under the plan. The CRA has published guidelines for determining a reasonable maximum level of funding of an RCA. As noted above, the amount is determined by estimating the amount needed to provide a reasonable pension benefit in relation to the employee's average pre-retirement salary and length of service or employment. An actuary will be needed to calculate the maximum that can be contributed to a plan for the plan to be regarded as an RCA by the CRA.

HOW ARE RCAs TAXED?

RCAs are subject to a 50% refundable tax on all amounts contributed to the RCA and all income earned in the RCA. Note that dividends and capital gains do not retain their preferential character in an RCA and are treated as ordinary income. The custodian is responsible for filing annual tax returns and reporting and remitting the refundable tax to the CRA.

The tax paid by the RCA is refunded when benefits are paid out under the plan. For every \$2 in benefits paid out, the RCA receives a refund of \$1.

Contributions are deductible to the contributor in the year that the contribution is made. The benefits are taxable to the recipient when they are received. The purpose of the 50% refundable tax is to prevent the creation of a deferral benefit that would arise from making deductible contributions while benefits are not taxed until received.

The 50% refundable tax can be quite punitive. For example, for an employee resident in Alberta, salary paid out directly would be taxable at a top rate of 39%. Using an RCA would require an 11% additional payment to CRA, which would only be refunded years later, without interest.

The impact of the 50% refundable tax on investments held in an RCA can be avoided in some circumstances. For example, income earned inside an “exempt” life insurance policy can accumulate tax-free. Increases in cash value within this insurance product as a result of income earned by the underlying assets would not be subject to the refundable tax (although the initial deposits to the life insurance product by the employer would still be subject to the tax).

HOW ARE THE TAX BENEFITS ACHIEVED?

As noted above, RCAs are beneficial when employees, including owner/managers, are anticipated to be taxed in lower tax brackets after retirement. This situation may arise where the recipient is anticipated to have little or no income from other sources (where, for example, the RCA would provide a bridge payment between retirement and the time that other pension/RRIF income begins), or to move outside Canada where distributions would be subject to only Canadian withholding tax, or to move to a province with significantly lower tax rates.

An RCA that pays survivor benefits can save on probate fees. The benefits payable to survivors passes outside the estate of the individual for whom the RCA was established, free of probate fees.

Retirement Planning for Key Employees and Owner/Managers of an Incorporated Family Business

Here is a general outline of the steps involved in using an RCA to save on taxes in the case of a key employee or the owner/manager of an incorporated family business:

- ❖ An RCA would be established to provide retirement benefits for the key employee or the owner/manager and his or her spouse.
- ❖ The corporation makes the contributions and receives a tax deduction for the contribution.
- ❖ The custodian then remits 50% of the amount contributed to the CRA on account of the applicable refundable tax and then invests the balance.
- ❖ The custodian remits 50% of the income derived from the amounts invested annually to the CRA on account of the refundable tax. (Income on funds invested through an “exempt” life insurance policy could be accumulated tax-free.)
- ❖ When the custodian pays benefits to the recipient under the terms of the plan, the custodian can claim a refund to the RCA of \$1 for every \$2 paid out.
- ❖ The custodian holds back the applicable withholding amount on account of the taxes payable by the recipient.
- ❖ If the recipient is in a low tax bracket or resident offshore, the tax payable or withheld may be substantially less than the tax refunded (e.g. the tax on benefits paid to recipients resident in non-treaty countries is 25%; the rate may be lower if the recipient is resident in a treaty country in which the treaty applies a lower rate).
- ❖ Tax has been reduced to the extent that the recipient is taxed at a lower rate when he or she receives benefits than would have been applicable if the contributions had been received as a bonus or salary or taxed in the business.

RCAs are particularly useful for the owner-manager of a Canadian controlled private corporation that consistently generates income in excess of the corporation’s small business deduction limit on active business income. If the Canadian controlled private corporation could not otherwise claim the small business deduction in respect of the amount paid, the contribution would have been taxed at the rate of 30.5% - 36.5% in the corporation (depending on its province of residence) and 39% - 48.3% if paid to the owner/manager (assuming that the owner/manager is taxed in the highest marginal tax bracket, and depending on the individual’s province of residence). Although the refundable

tax is always higher than the applicable tax rate, the up-front tax cost may, in some circumstances (as discussed above), be offset by the future tax savings.

ARE THERE PITFALLS IN USING AN RCA?

Care must be taken in establishing and funding an RCA. Falling offside CRA guidelines may result in a challenge by the CRA as to the validity of the RCA. Also, the CRA has expressed concerns regarding plans in which amounts contributed to an RCA have been loaned back to the contributor. The CRA may challenge the deductibility of contributions to such plans.

OTHER ISSUES

An RCA may come under federal or provincial pension regulation (although some provinces such as Ontario, Manitoba and Saskatchewan specifically exclude RCAs from pension regulation). The terms of the plan and the applicable federal or provincial legislation should be examined to determine whether a specific plan would be regulated under pension legislation. Where a particular plan falls under pension regulation, the amounts payable under the plan may be exempt from execution, seizure or attachment at the instance of the recipient's creditors.

CONCLUSION

With proper planning, RCAs are a useful tool and may provide significant tax savings and other benefits. We recommend that appropriate financial, legal and accounting advisors be consulted prior to implementing any plan involving RCAs.