TAX
ALERT

COLLINS BARROW

Share now

July 2017

What is a Retirement Compensation Arrangement ("RCA")?

***Jesse Genereaux** is a tax manager in the Durham office of Collins Barrow*

An RCA is a plan that is funded by contributions from employers and employees to a custodian who manages the funds. RCAs are used to fund the retirement of an employee, their loss of employment or a substantial change in the services that they provide.

How it works?

Employers make annual tax deductible contributions to an RCA that are subject to a refundable 50% withholding tax. Since the payments are not made to the employee, they are not subject to any tax implications in the year the contributions are made. When payments are made from the plan to the employee, the refundable taxes paid are recovered at the same rate (e.g. $1 of every $2 paid). All income earned within the plan is subject to the refundable 50% tax and is recoverable at the same rate as above. The employee pays personal tax on distributions from the RCA in the year they are received.

Employees can also make tax deductible contributions to an RCA. The contributions are similarly considered deductible and subject to the 50% refundable withholding tax.

Types of plans

An RCA can be set up as either a Defined Benefit Plan ("DBP") or a Defined Contribution Plan ("DCP"). As the title suggests, a DBP provides employees with a defined pension amount annually, upon retirement. Whereas employees on a DCP will receive only what was contributed to the plan, plus any income earned or less any losses incurred, a DBP will require the periodic involvement of an actuary to determine whether the plan is properly funded.

A DBP puts the risk of losses on investments in the hands of the employer and a DCP passes that risk to the employees as they will receive what is remaining in the plan.

Who will benefit from RCAs?

Employees

Employees who participate in an RCA will enjoy future pension benefits and peace of mind knowing that, if the employer were to close down and they lost their employment, the assets of the RCA would be protected against the creditors of the employer.

The 50% refundable withholding rate is currently less than the top tax bracket in a number of provinces. As such, the after-tax investment for the pension is no longer considered a disadvantage to RCAs for high-income earning employees as the plan will invest 50% of the amount they are paid as opposed to less than 50%, had they been paid as a salary.

Contributions to the RCA by an employer will not reduce the RRSP contribution room for the employee, which is not the case for contributions made to a Retirement Pension Plan ("RPP").

Further tax savings can be obtained by paying the employees out of the RCA in future years when their income levels are lower and subject to lower marginal tax rates. When you consider the ability to include income in lower income earning years, employees living in provinces and territories not subject to >50% tax at the top rate can still benefit from an RCA.

Employers

Employers may wish to provide a retirement package for their employees but not pay the high costs of operating an RPP or an Individual Pension Plan ("IPP"). If the owner-manager of the

July 2017

What is a Retirement Compensation Arrangement ("RCA")?

company or someone already within the company completes the required remittance forms and bookkeeping for the plan, the costs associated with an RCA would include the preparation of the trust return, identified above, and investment advisor fees, if an advisor is used. Additional costs may be applicable for DPBs since possible periodic actuarial valuations may be needed to ensure the plan is properly funded.

Employers can also utilize RCAs for what's referred to as "Golden Handcuffs," meaning they can require an employee to meet certain length-of-employment requirements before the pension contributions vest. This will help employers retain key employees that are vital to their operations.

Tax benefits for employer

One group that may benefit most from these plans are companies involved in Scientific Research and Experimental Development ("SRED") that must maintain low taxable income and taxable capital figures to retain their benefits from the enhanced investment tax credits. Since the taxable income and taxable capital figures exceed $500,000 and $10,000,000, respectively, the amount eligible for the enhanced tax credit decreases.

Federally, expenditures eligible for the enhanced tax credit are eligible for a 35% tax credit, whereas expenditures not eligible only provide for a 15% tax credit. When you also consider the provincial tax credit implications, it's critical for these companies to maintain sufficient expenditure pool levels.

One common method for ensuring low income and taxable capital figures is to declare bonuses for the owner-managers and to pay those bonuses out of the company to reduce taxable capital. This is a good opportunity to use RCAs. The top tax rate in seven of Canada's thirteen provinces or territories is over 50%. Given the RCA withholding rates are currently 50%, this can provide a deferral of up to 4% depending on your province. When you add the additional payroll costs, this can result in significant savings.

How much should be contributed?

An employer must be careful not to contribute an unreasonable amount to the plan on behalf of an employee as it could result in the plan being re-characterized as an SDA. The starting point for a reasonable DCP amount would be the 18% that is used to create RRSP deduction room annually. A higher rate would likely require a very strong argument as to why it's reasonable.

A DBP requires a certain level of assets to be held within the plan to support the future pension obligations that an actuary has calculated. Given that the plan will require a certain amount, a reasonable contribution will be the amount that brings the assets of that plan to a sufficient level to fund that obligation. The pension benefit, however, must be considered a reasonable amount. Again, a reasonable amount will vary based on the facts of each situation.

The CRA has indicated that it will permit a deduction for recognition of an employee's years of services even if it occurred prior to the establishment of the RCA.[1] Since past years of service can be recognized, large contributions may be eligible when the RCA is initially established.

Careful planning is required to ensure that the plan meets the criteria of an RCA as adverse tax effects could result otherwise. You should seek professional advice if you are setting up an RCA.

Jesse Genereaux *is a tax manager in the Durham office of Collins Barrow.*

[1] 2004-0082991E5