THE NAVIGATOR

RETIREMENT COMPENSATION ARRANGEMENT (RCA)

Most business owners and professionals are often left in a state of shock when they see the small percentage of post retirement income provided by their Registered Retirement Savings Plan (RRSP). RRSPs are based on the premise that an annual contribution of 18% of earnings will provide an individual with an adequate retirement income. However, for higher income earners earning more than $100,000 per year, this often leaves them with pension benefits that are significantly lower than the acceptable 50% to 70% of pre-retirement income. Fortunately, the Income Tax Act provides a way to bridge the gap for business owners and professionals using a retirement planning solution called a Retirement Compensation Arrangement (RCA).

WHAT IS AN RCA?

Section 248(1) of the Income Tax Act (the Act) defines an RCA as a plan or arrangement under which an employer, former employer or, in some cases, employee makes contributions to a custodian. The custodian holds the funds in trust with the intent of eventually distributing them to the employee (beneficiary) upon, after or in view of retirement, loss of office or loss of employment, or any substantial change in the service the employee provides.

An RCA is an inter vivos trust relationship, which is governed by a trust agreement. Akin to any other trust arrangement, it sets out the powers of the custodian, investment of the trust fund, responsibilities and limitations of the parties and resignation, removal and replacement of the custodian. The company establishing the RCA and the trustee/custodian of the RCA sign the trust agreement.

WHY AN RCA?

An RCA is sometimes referred to as a "super-sized pension plan" because there are no set limits on the amounts that can be contributed to the plan, provided those amounts are "reasonable" (see discussion in the "What is reasonable?" section).

An RCA is intended to provide supplemental pension benefits for business owners and senior executives who wish to maintain their standard of living in retirement. Typically, an RCA is used as part of a retirement plan, which may also include an Individual Pension Plan (IPP) set up by the employer. An RCA may also be utilized to provide pension benefits to an employee or group of employees in situations where a company does not have a Registered Pension Plan (RPP) in place.

REFUNDABLE TAX ACCOUNT (RTA)

When an employer makes a contribution to an RCA, 50% of the contribution is deposited with the custodian of the RCA trust to be invested in an investment account, and the other 50% is deposited with the Canada Revenue Agency (CRA) as a refundable tax to be held in an RTA. The RTA is a non-interest-bearing account that accumulates the tax until a payment is made out of the RCA and the tax is refunded to the RCA.

In addition, 50% of all dividends, realized capital gains and interest income less expenses earned in the investment account must be remitted to the RTA on an annual basis. That is, Canadian dividends and capital

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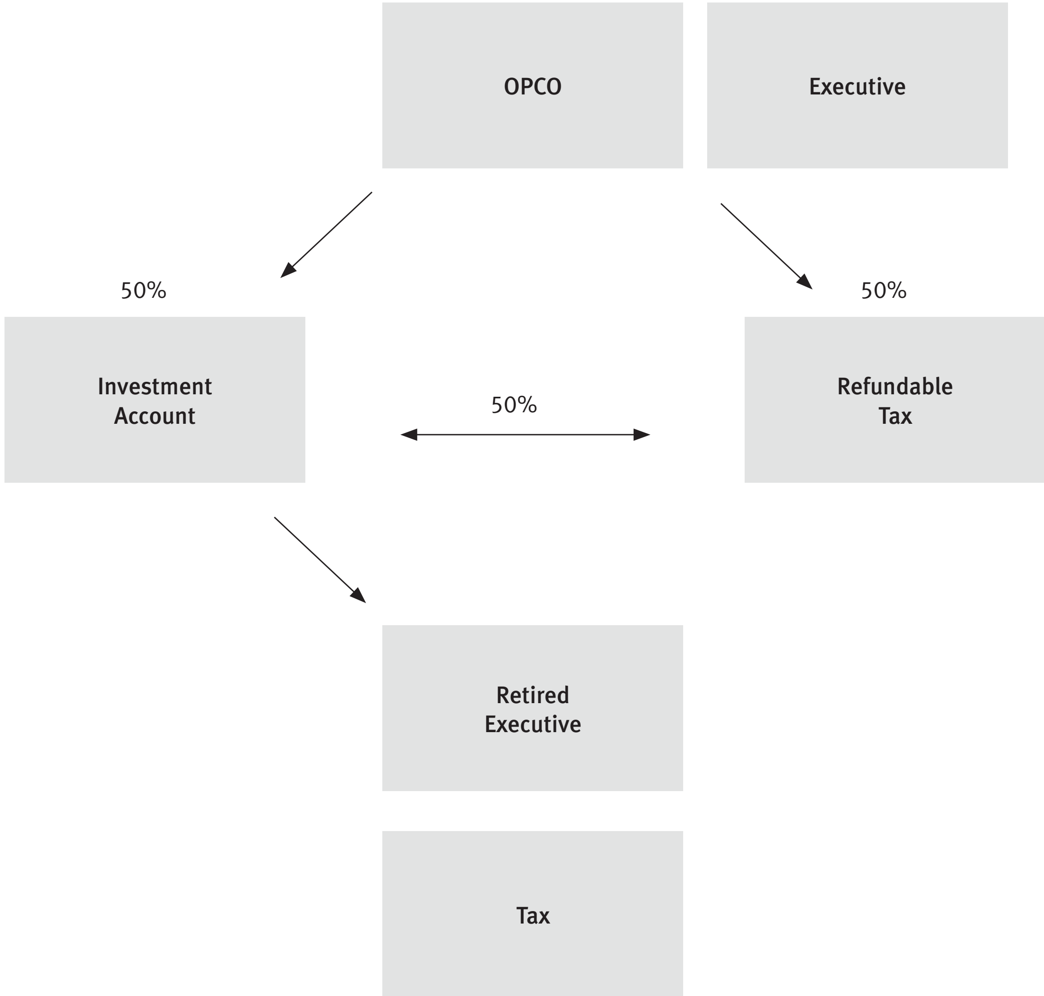
Structure of an RCA



Legend

OPCO	Operating company contributing to the RCA.
←→	50% of all dividends, realized capital gains and interest income must be remitted to the RTA.

The CRA also allows tax-deductible contributions by the employee, provided the contributions do not exceed those of the employer and there is an employment agreement in place outlining the required participation of the employee in the RCA.

An RCA payment is considered a retiring allowance, and the eligible portion may be rolled into an RRSP.

gains do not receive preferential tax treatment in an RCA the way they do in a personal non-registered investment account or regular trust account.

When benefits are paid to the beneficiary of an RCA, $1 for every $2 paid out of the RCA trust is refunded to the custodian of the trust through the RTA. It is possible to recover 100% of the RTA balance if the full amount of taxable contributions and taxable income in the RCA are paid out to the beneficiary.

Taxation of an RCA

Contributions to an RCA are 100% tax-deductible to the employer. There is no limit to the amount of contributions an employer can make to an RCA, provided the amounts are "reasonable" (see discussion in the next section) and not excessive relative to the target retirement compensation to be provided. To prevent an RCA from being deemed by the CRA a salary deferral arrangement, most employers retain an actuarial firm or insurance company to conduct an actuarial valuation.

The CRA also allows tax-deductible contributions by the employee, provided the contributions do not exceed those of the employer and there is an employment agreement in place outlining the required participation of the employee in the RCA. However, employee contributions will reduce the amount that may be contributed by the employer.

All distributions out of an RCA trust to a beneficiary are fully taxable. When an employee, or former employee, receives payments from an RCA trust, the income is treated as "other income" and taxed at the employee's marginal tax rate. RCA income is not considered eligible pension income for the purpose of income splitting with a spouse, nor is it considered earned income for RRSP contribution room. However, an RCA payment is considered a retiring allowance, and the eligible portion may be rolled into an RRSP.

What Is Reasonable?

The Act does not define limits for reasonable contributions to an RCA. In order to assist actuaries in determining reasonable contributions to an RCA, the CRA has provided the following generally accepted guideline:

"A normal level of benefits would be the same benefit provided under a

RCA assets can be invested in mutual or pooled funds, stocks, bonds, T-bills, guaranteed investment certificates and life insurance policies.

registered pension plan without regard to the Revenue Canada maximum. This would be 2% x years of service x final five-year average earning or about 70% of pre-retirement income for an employee with 35 years of service." (CRA Roundtable discussion, 1998).

In other words, the CRA allows the formula used for a defined benefit pension to be used for an RCA, except the salary amount is not subject to a maximum, which allows the RCA contributions to exceed pension plan contributions and to be more in line with the salary of the employee.

In special circumstances, it is possible to deviate from these guidelines and use a higher percentage, such as in the case of a professional athlete where their career span is much shorter.

RCA Investments

RCA assets can be invested in mutual or pooled funds, stocks, bonds, T-bills, guaranteed investment certificates and life insurance policies. However, in order to minimize the amount to be remitted to the RTA, the custodian may consider strategies such as a buy and hold strategy or insurance solutions.

The 2012 budget proposes to introduce new "prohibited investment" and "advantage" rules to directly prevent RCAs from engaging in non-arm's length transactions. These rules will be based very closely on existing rules for Tax-Free Savings Accounts and Registered Retirement Savings Plans.

Insured RCAs

Since the fund value of an exempt life insurance policy accumulates on a tax-deferred basis, an exempt life insurance policy is an attractive investment for an RCA. One of the key advantages of utilizing an exempt policy is that the investment income earned within the policy is tax-exempt, and thus, not subject to the 50% refundable tax. As such, the investment compounds at pre-tax rates.

As a result, if the employee is a few years away from retirement, the accumulation within the life insurance policy may outperform alternative investment vehicles earning similar returns, resulting in the employer having to make fewer contributions to achieve the same results.

The tax effectiveness of this strategy is, however, reduced when the funds are withdrawn from the life insurance policy. A partial withdrawal will result in a partial disposition for tax purposes. And the resulting policy gain will be included in the income of the RCA trust and subject to the 50% refundable tax liability.

Also, death proceeds from the insurance policy are paid to the RCA tax-free, but are taxable in the hands of the recipient (the beneficiary of the RCA or the deceased's spouse). **In effect, this strategy converts what would otherwise be tax-free income (insurance proceeds) into taxable income (distribution from an RCA).** A partial solution to this quandary is to utilize leveraging techniques to access the accumulated values within the life insurance policy. For example, the RCA trust could purchase a life insurance policy on the life of the executive. The insurance policy would be funded using the contributions made to the RCA trust. At the time of the employee's retirement, the RCA trust would fund a portion of the retirement benefits with bank loans using the life insurance

Upon death, proceeds from an RCA are not subject to probate fees.

policy and the RTA as collateral. Insurance death benefits would then be used to pay off the bank loans.

Leveraging RCAs

It is possible to incorporate an RCA in a variety of leverage strategies including the use of an insurance contract. However, please note that the primary reason for setting up an RCA should be for retirement planning and not leveraging purposes. The CRA has indicated that they will closely examine and attack an RCA where the intentions for setting up the RCA are questionable. For example, the CRA has stated that "where funds are contributed by an employer to a custodian for the benefit of persons who are not dealing with the employer at arm's length and the custodian lends the amount back to the employer," it is questionable whether the RCA exists.

Annuities

When the custodian of an RCA trust buys an annuity contract for the beneficiary of an RCA, the CRA views the amount paid to purchase the annuity as a taxable distribution out of the RCA trust to the beneficiary. The full amount is taxable in the year the custodian buys the contract, and the custodian has to issue a T4A-RCA slip showing the amount of the distribution and the income tax deducted.

Advantages of an RCA

- RCA contributions do not affect RPP contributions; however, RPP/IPP contributions reduce the amount that can be contributed to an RCA.
- Employer or employee contributions to an RCA do not affect RRSPs as they don't generate a pension adjustment (PA) or RPP contribution limit and are not regulated under provincial pension legislation.
- A contribution to an RCA provides an immediate deduction to an employer at current tax rates and is not taxable to the employee until the employee receives the benefit in a future year, potentially when the employee is in a lower tax bracket. However, keep in mind that the contributions to the RCA are subject to a 50% refundable tax.
- An RCA provides flexible investment options due to the fact that it has no investment restrictions.
- Upon death, proceeds from an RCA are not subject to probate fees.
- RCA contributions are exempt from payroll and healthcare taxes.
- The RTA is an asset of the RCA trust, and thus, could be used as leverage to secure a loan (caution against loan back to employer corporation).
- Unless pledged as collateral for a loan or fraudulently conveyed, RCAs are creditor protected.

Disadvantages of an RCA

- The refundable tax rate of 50% results in a prepayment of tax in all provinces except Nova Scotia, where the highest marginal tax rate is 50% and no deferral or prepayment exists. Since Alberta has the lowest personal top marginal tax rate of any other province in Canada, the prepayment in Alberta is approximately 11%. Consequently, the prepayment of tax makes RCAs more attractive to Nova Scotia residents than Alberta residents.
- The RTA is a non-interest-bearing account.
- There are initial setup fees, ongoing management fees, and there may be compensation paid to the custodian for administering the RCA trust.
- The custodian has to file a T3-RCA tax return each year, even if there has been no activity in the RCA trust in the year.

Non-Resident Tax Treatment

Withdrawals from an RCA by a non-resident beneficiary are subject to a 25% Canadian non-resident withholding tax. This Canadian non-resident withholding tax may be lower if the beneficiary is resident in a country that has a tax treaty with Canada. The tax treatment of RCA income and RCA withdrawals in the beneficiary's country of residence depends on their local tax rules.

Speak to your qualified cross-border tax advisor if you are considering setting up an RCA for a U.S. person.

Prior to changes in the U.S. tax laws in 2004, it was tax favourable for a U.S. taxpayer to receive payments from an RCA. However, based on current legislation, a U.S. taxpayer is subject to 25% Canadian non-resident withholding tax on RCA distributions. If an RCA is set up for a U.S. person, then it is imperative that the U.S. non-qualified deferred compensation rules in section 409A of the Internal Revenue Code be considered.

Speak to your qualified cross-border tax advisor if you are considering setting up an RCA for a U.S. person. Speak to your RBC advisor for a copy of the article "Tax and Estate Planning for U.S. citizens in Canada" if you are a U.S. citizen and you are interested in learning more about tax planning in Canada.

When to Consider an RCA

Given the aforementioned advantages and disadvantages of RCAs, you may consider an RCA in the following scenarios:

- An RCA may be used as "golden handcuffs" to reward long years of service and entice top executives to remain with the company to guarantee payments to them out of the RCA during retirement. An RCA contract provides flexibility in setting the terms of payment and participation.
- An RCA may be used by an owner manager contemplating moving and retiring outside Canada or in a province with a lower tax rate than that of their current province of residence. The disadvantage of prepayment of tax may be overlooked if the overall tax bill when payments are received is reduced.
- An RCA may be used as part of an insurance/leverage strategy as mentioned in the "Insured RCAs" and "Leveraging RCAs" sections.
- An RCA may be considered in contemplation of a sale of the assets of a business in the long run. It is important that the RCA be set up, funded and secured well in advance of the time of sale, with the intention of supplementing the owner's pension/retirement funding. The CRA may challenge the RCA if the intent appears to be driven by the sale of assets, not retirement planning. The sale of the assets may trigger recapture and capital gains in the corporation, which may be offset by the deduction claimed for the RCA contributions.

RCA at Death

There are no tax consequences to an RCA or employee as a result of the death of the employee. The beneficiary named in the plan (or the estate) will receive the payments out of the RCA,

If you feel an RCA may be right for you, please contact your RBC advisor to have an RCA illustration prepared for you based on your circumstances.

subject to withholding tax, and be subject to taxation on the amounts as other income.

RCA Tax Reporting

An annual T3-RCA tax return must be prepared even when the RCA doesn't have any transactions. When payments are made to an employee, a T4A-RCA is issued to the employee to report the amount paid and withholding taxes applicable. An NR4 is issued when the plan member receiving the RCA payment is not a resident of Canada.

RCA vs. Individual Pension Plans (IPPs)

An IPP is a registered, defined benefit plan sponsored by an employer. Like an RCA, contributions by an employer to an IPP are tax-deductible to the employer. However, while RCAs supplement RRSPs, IPPs replace them. The IPP is used as an alternative to an RRSP as it offers higher deductible contributions than an RRSP; the contributions increase with age, whereas the maximum RRSP contributions are set; and the assets of an IPP are creditor protected. IPP retirement benefits are subject to a maximum, and as a result, the RCA may be considered a supplement to IPP retirement benefits for high income earners.

RCA Illustration

If you feel an RCA may be right for you, please contact your RBC advisor to have an RCA illustration prepared for you based on your circumstances. Along with your tax and legal advisors, your RBC advisor can assist you in deciding if an RCA is appropriate for you.

Please contact us for more information.

Please contact us for more information about the topics discussed in this article.

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