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FINANCIAL ADVISORY SUPPORT

Pensions Part 3 — Deferred Profit Sharing Plans

This article is the third part of a four-part series on employer retirement plans. Due to the complexity and variety of employer retirement plans, instead of one lengthy article, we have broken down the content into four separate articles: Defined Benefit (DB) Registered Pension Plans, Defined Contribution (DC) Registered Pension Plans, Deferred Profit Sharing Plans (DPSPs) and Group RRSPs. This article gives a detailed overview of how DPSPs work.

In all the articles, the term "pension plan" refers to an employer-sponsored retirement plan — not a government pension plan like the Canada Pension Plan (CPP) or Quebec Pension Plan (QPP).

A metaphor that is sometimes used for retirement planning is the three-legged stool — that is, your retirement income sources can be thought of as the legs of a three-legged stool. In order to have a financially secure retirement, all three legs of the stool should be sturdy enough to keep the stool upright. The three legs of the retirement income stool are:

- Government income sources (e.g., CPP/QPP and Old Age Security (OAS))
- Employer retirement plans or pensions
- Personal savings (RRSPs and non-registered savings)

(Note that in some cases, you may have adequate personal savings or an adequate employer pension to have a financially secure retirement even though one or two of the other legs are not significant contributors.)

This series of articles is intended to provide you with information on the employer retirement plans leg of the retirement income stool.

Due to pension legislation being different among the various provinces and territories and due to each pension plan having its own unique terms, there may be situations where the information in the articles will not apply to a specific employer retirement plan. Therefore, it is imperative that you consult your employer's pension administrator for final confirmation on any questions you may have on your employer retirement plan.

What is a DPSP?

A DPSP is a type of tax-sheltered retirement plan that is set up by an employer for the benefit of its employees. An employee who owns 10% or more of the employer's shares or is related to such a person cannot become a member of a DPSP. Income earned within a DPSP grows tax-deferred, similar to an RRSP. Qualified investments for a DPSP are also similar to qualified investments for an RRSP; however, a DPSP cannot invest in bonds, debentures and other debt obligations of the employer who is making payments to the plan.

In general, an employee is fully vested in the plan after **24 consecutive months** of plan membership. Once vested, the funds accumulating in the DPSP can generally be withdrawn at any time, unless the terms of the plan provide that the funds must remain locked-in until the member terminates plan membership or retires.

Contributions

Only employers are permitted to make contributions to a DPSP. The amounts that the employer contributes are normally calculated as a percentage of profits (e.g., 5% of profits as defined in the plan), but can be calculated on another basis as long as they are paid out of profits.

These contributions are subject to an annual maximum of the lesser of 18% of the member's current year compensation or $11,225 (half of the 2010 DC plan limit). However, a DPSP can permit employers to make contributions at their discretion or contingent upon a prerequisite, such as employee performance, without requiring the employer to make a minimum contribution.

Taxation issues

The employer's contributions to the DPSP are deductible to the employer and are not considered a taxable benefit to the employee.

Pension Adjustment (PA)

The annual PA under a DPSP plan is equal to the employer contributions to the DPSP plan for the current year.

The employer's contributions to the DPSP are added to the employee's PA for the current year, which is reported by the employer in box 52 of the employee's T4 slip. The PA reduces the employee's RRSP deduction limit for the following year.

The purpose of a PA is to reflect the value of the tax-deferred benefits that an employee is receiving by being a member of an RPP or DPSP. If a PA is reported by the employer on the member's T4 slip, then the amount of the PA will reduce the member's unused RRSP deduction limit for the **following year**. There is a one-year deferral before the PA has an impact.

PA reporting began in 1990. The objective was to attempt to equalize the tax-deferred retirement benefits individuals receive whether or not they are a member of a tax-deferred company retirement plan.

Example

Assume Mr. Jones and Mrs. Smith have the same earned income of $50,000. However, Mr. Jones is a member of a DPSP, whereas Mrs. Smith is self-employed and not a member of a company pension plan. As Mr. Jones is a member of a DPSP, contributions are being made for him to a tax-deferred retirement plan. However, as Mrs. Smith is not a member of a company retirement plan, her main source of saving in a tax-deferred retirement vehicle is through her personal RRSP. To allow both Mr. Jones and Mrs. Smith to accumulate annual tax-deferred retirement savings of similar amounts, Mr. Jones' employer reports a PA for the contributions made to Mr. Jones' DPSP plan. The PA that Mr. Jones receives reduces the contribution that he can make to a personal RRSP for the following year. Mrs. Smith receives no PA and as a result can make a greater RRSP contribution than Mr. Jones can to help her make up for not being a member of a company tax-deferred retirement plan.

Options at termination or retirement

If an employee terminates the DPSP before two years of plan membership, then they forfeit the employer's contributions plus interest. However, if employer contributions to the DPSP are forfeited, the employer will be responsible for calculating a Pension Adjustment Reversal (PAR) equal to the amount of the employer contributions that were forfeited. The PAR will increase the employee's unused RRSP contribution room in the year of termination.

The concept of the PAR was introduced in the 1997 Federal Budget with the objective of providing fair treatment to those who leave pension plans and receive far less from those plans than the amount by which their RRSP contribution limits have been reduced by PAs over the years. That is, an employer's contributions made to the DPSP create a PA in the year of the contribution, which means that the member's RRSP deduction limit for the following year is reduced. Without a PAR, the member will not only lose the employer's contribution plus interest due to early termination, but they will also be penalized for past contributions due to PA reporting, and thus, have a lower RRSP deduction limit due to those same forfeited contributions. To eliminate this inequity, a PAR can be calculated to allow the member to recover the lost RRSP deduction room that relates to the forfeited employer contributions.

If an employee is vested in the DPSP and the plan allows it, the employee has the following maturity options for their vested DPSP funds:

- Receive a lump sum in cash. This will be fully taxable unless it is a return of pre-1991 employee contributions, or the employee can utilize the opportunity described in the next section;

- Roll over the funds on a tax-deferred basis to a non-locked-in RRSP of which the employee is the annuitant. This does not require equivalent unused RRSP deduction room since a PA was generated when the employer made the contributions to the DPSP;

- Roll over the funds on a tax-deferred basis to an RPP or another DPSP with at least five beneficiaries;

- Receive equal payments annually over a maximum of 10 years;

- Purchase an annuity from an insurance company with a guarantee period of no more than 15 years;

- Utilize the planning opportunity in the next section if the employer's stock is held as an investment in the DPSP.

Note that some plans may allow employees to take advantage of these options with their vested DPSP funds, even if the employee is not terminating their employment or retiring.

DPSP planning opportunity

Another potential maturity option exists when the DPSP holds the employer's stock as an investment. The employee may be able to transfer the vested employer stock out of the DPSP into their non-registered account, pay tax immediately based on the **cost** of the stock and convert the future growth above the cost into income taxed at the **capital gains rates**.

For example, assume the cost of the employer's stock held within the DPSP is $10,000 and the current fair market value is $50,000. Normally when stock is transferred in-kind out of a registered plan to a non-registered account, its fair market value on the date of the transfer is included in the plan holder's income for tax purposes, and the fair market value of the stock on that date becomes its new adjusted cost base (ACB).

Under normal circumstances, if all the stock is transferred in-kind out of the tax-sheltered DPSP to a non-registered plan, the employee will have to pay tax immediately at their marginal tax rate on $50,000 of income. However, if the employee terminates their interest in the DPSP and completes **CRA Form T2078**, they can transfer the employer's stock in-kind from the DPSP to their own non-registered account and pay tax immediately only on the **cost** of the stock or $10,000.

If the employee later disposes of the stock in the non-registered account for $50,000, they will have to include the $40,000 increase as income on their tax return. **However 50% of this $40,000 income inclusion, or $20,000, can be claimed as a tax deduction, so only $20,000 is included in the employee's income. The result is that the increase in value is taxed in the same way as if it had been a capital gain.**

The disadvantage of this strategy is that the employee makes a prepayment of tax on $10,000 compared to the other option of rolling all the stock on a fully tax-deferred basis into a non-locked-in RRSP. The benefit of this strategy is that the value of the stock above $10,000 will eventually be taxed in the same way as a capital gain upon disposition, instead of it being taxed as regular income, as it would be if it was rolled over to the RRSP and eventually withdrawn.

There are potential tax savings in transferring the employer stock to a non-registered account and then later disposing of the stock in a non-registered account compared to rolling the stock into an RRSP and making a withdrawal from the RRSP later on. Assuming that the sale proceeds in the non-registered account are $50,000 and the withdrawal from the RRSP is also $50,000, **the non-registered alternative method using Form T2078 would result in a tax saving of $9,200, based on a marginal tax rate of 46%** [($50,000 RRSP income x 46%) – ($10,000 x 46% + ($40,000 – $20,000) x 46%)]. However, the cost of the prepayment of tax on the $10,000 for an individual taxed at a marginal tax rate of 46% would be $4,600. This should be factored in from a cost-benefit standpoint. This could result in a saving of $4,600 ($9,200 – $4,600).

In a case where the employee already held the identical employer stock in a non-registered account before the transfer of the employer stock from the DPSP to the non-registered account using Form T2078, the employer stock previously held in the non-registered account is deemed to have been disposed of first. Therefore, the weighted average cost rule of identical properties does not apply in this case.

Survivor benefits

If an employee dies with funds that are vested in a DPSP, these funds can be rolled over on a tax-deferred basis to their surviving spouse's or common-law partner's RRSP or RPP, but not to a RRIF. If there is no surviving spouse or common-law partner, the DPSP funds will be taxable to the surviving beneficiary.