Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

Deferred profit sharing plans

A deferred profit sharing plan (DPSP) is an employer-sponsored profit sharing plan that's established as a trust and registered with the Canada Revenue Agency (CRA). It's a type of registered tax-sheltered retirement plan. The purpose of a DPSP is to permit an employer to share profits with its employees. A DPSP can be set up for all employees or a certain group of employees. However, "specified shareholders" and individuals related to the employer cannot participate in the DPSP. Generally, you're a specified shareholder if you own at least 10% of any class of your employer's shares or are not dealing at arm's length with such a shareholder.

Contributions

Only employers are permitted to make contributions to a DPSP. The contributions to a DPSP should be defined by the plan and calculated by reference to profits or paid out of profits. They can be a percentage of the employer's profits or a percentage of the member's earnings. The DPSP can permit employers to make contributions at their discretion or make contributions contingent upon a prerequisite, such as employee performance, with no requirement for the employer to make a minimum contribution.

Although there's no annual minimum contribution requirement, a DPSP is subject to an annual maximum contribution per member. This annual maximum is equal to the lesser of 18% of the member's current-year compensation from the employer, or the current-year's DPSP limit (which is equal to half of the defined contribution pension plan limit). The annual DPSP limit can be found on the Government of Canada's website.

If, through your employer, you also participate in a registered pension plan (RPP), such as a defined contribution (DC) or a defined benefit (DB) pension plan, the annual maximum contribution to your DPSP will be reduced. This is because contributions to a DPSP or an RPP result in pension credits and there's an annual maximum amount of pension credits allowed for each individual. Contributions to a registered retirement savings plan (RRSP) do not result in pension

credits and would not be considered in determining the annual maximum contribution to a DPSP.

Tax considerations

Employer contributions to a DPSP are deductible to the employer and are not considered income to you at the time the contribution is made. You do not pay tax on the contributions that are made to a DPSP for your benefit. The contributions and investment earnings accumulate tax-deferred while they are in a DPSP, but are included in your income for tax purposes when withdrawn. DPSP contributions made on your behalf in a particular year reduce your RRSP contribution room for the following year.

Pension adjustment

A pension adjustment (PA) is the value of the benefits you earned in the year under your employer's DPSP and RPP. The amount of your employer's contributions to the DPSP on your behalf for the current year results in a PA for the year. The PA is reported in Box 52 of your T4, *Statement of Remuneration Paid,* and will reduce your RRSP contribution room for the following year.

Qualified investments

Qualified investments for a DPSP are similar to those for an RRSP. A DPSP cannot invest in bonds, debentures, notes, bankers' acceptances or similar debt obligations of the employer who's making contributions to the plan. Unlike RPPs, DPSPs do not have a limit on the percentage of shares of any one company that it may invest in. Therefore, a DPSP may invest heavily in the shares of the employer.

Vesting

Vesting refers to earning a non-forfeitable right to the benefits under the DPSP in the event of termination of employment, retirement or death.

Amounts allocated to you under a DPSP must vest immediately if you've been a member of the plan for two years. If you have not been a member of the DPSP for two years, amounts allocated to you must vest upon completion of 24 consecutive months as a member. However, the terms of the DPSP can allow for earlier vesting.

Withdrawals

Once vested, it may be possible to withdraw funds from the DPSP. However, your employer can impose restrictions on withdrawals while you're still employed and can also apply withdrawal fees.

The amount you withdraw from your DPSP is taxable as regular income at your marginal tax rate in the year you withdraw it. Your employer must deduct withholding tax on the amount you withdraw from your DPSP as a lump sum. The percentage for withholding will depend on the total

Once vested, it may be possible to withdraw funds from the DPSP. However, your employer can impose restrictions on withdrawals while you're still employed and can also apply withdrawal fees.

amount of the lump sum taken for the year and are the same rates that apply to RRSP withdrawals. The lump-sum withdrawal from your DPSP will be subject to the following federal and provincial or territorial combined rates:

- 10% (20% for Quebec) on amounts up to and including $5,000
- 20% (25% for Quebec) on amounts over $5,000 up to and including $15,000
- 30% (30% for Quebec) on amounts over $15,000

Your employer will report the DPSP lump-sum withdrawal amount in Box 18, and the withholding amount in Box 22 of a T4A, *Statement of Pension, Retirement, Annuity, and Other Income*.

Termination or retirement

All vested amounts in your DPSP must become payable to you 90 days after the earliest of your date of death, the date on which you leave your employer, and the termination or winding-up of the DPSP, but no later than the end of the year in which you turn 71.

If you terminate your employment before you're fully vested in your DPSP, you may forfeit the unvested portion, but this depends on the terms of your DPSP. Amounts allocated to you that have not vested at the time you leave your employer can, depending on the provisions of the plan, be paid out to you. It's also possible for the plan to provide for vesting of amounts allocated to you either at the time you leave your employer or at any time after you leave. If you have amounts that are forfeited, your employer will be responsible for calculating a pension adjustment reversal (PAR) equal to the amount of the contributions that were forfeited.

Pension adjustment reversal

The PAR restores your RRSP contribution room when you receive benefits from a DPSP that are less than the amount of RRSP contribution room given up because of your membership in the DPSP. As discussed previously, employer's contributions to the DPSP for your benefit created a PA, which reduced your RRSP contribution room. Generally, you would have a PAR related to your DPSP only when you're not fully vested on termination from the DPSP and amounts have been forfeited. For additional

information on PARs, ask your RBC advisor for the article on this topic.

Options available on termination or retirement

You have the following options available to you on termination or retirement, provided your plan allows for them:

- To receive a lump-sum payment in cash. This will be fully taxable in the year you receive it unless it's a return of pre-1991 employee contributions (when non-deductible employee contributions were allowed).
- To receive equal annual (or more frequent) instalments over a maximum of 10 years from the day on which the amount becomes payable. The amounts are taxable in the year you receive them.
- The trustee of the DPSP can purchase an annuity from an insurance company as long as the annuity begins by December 31 of the year you turn 71 and, if it has a guaranteed term, such a term must not be more than 15 years.[1] Payments from the annuity will be taxable in the year you receive them.
- To directly transfer an amount that's not part of a series of periodic payments on a tax-deferred basis to a non-locked-in RRSP, a non-locked-in registered retirement income fund (RRIF), an RPP, a pooled registered pension plan (PRPP) or a Saskatchewan Pension Plan (SPP) of which you are the annuitant. This transfer does not require equivalent RRSP contribution room. Funds must be transferred directly using CRA Form T2151.
- To directly transfer an amount that's not part of a series of periodic payments on a tax-deferred basis to another DPSP, as long as the other DPSP can reasonably be expected to have at least five beneficiaries throughout the calendar year in which the transfer is made.
- To utilize the deferral planning opportunity discussed in the next section. This planning opportunity is only available if you receive a single payment from the DPSP that includes shares of the corporation that was your employer who contributed to the DPSP (your "employer corporation"), or shares of a corporation with which your employer does not deal at arm's length.

DPSP deferral election – withdrawal includes shares of your employer

If you receive a single payment out of a DPSP as a complete withdrawal from the plan and the payment includes shares of your employer corporation or shares of a corporation with which your employer does not deal at arm's length (collectively referred to as the "employer shares"), you have another option. This article refers to this option as the DPSP deferral election option. Normally, you would have to include the full fair market value (FMV) of the shares in income in the year they're withdrawn from the DPSP. However, you have the option to transfer the employer shares from the DPSP to your non-registered account and file a tax election to reduce the amount otherwise required to be included in your income. The reduction represents the capital gains that have accrued on the shares while held in the DPSP.

You must use CRA Form T2078, *Election Under Subsection 147(10.1) for a Single Payment Received from a Deferred Profit Sharing Plan,* to make the election and the election must be made for all of the employer shares included in the single payment. An election is not permitted on only some of the shares. To make the DPSP deferral election, you must be resident in Canada at the time you received the single payment from your DPSP. The election is available when you completely withdraw from the plan, retire from employment, or when you pass away.

The result of making this tax election is that you will only pay tax on the cost amount of the shares to the DPSP in the year of withdrawal and can defer the tax on the growth that accrued while the shares were held in the DPSP. You can defer the tax on the growth until you dispose of the shares or are deemed to dispose of them. At that time, the growth that accrued while the shares were held in the DPSP will be included in your income as ordinary income but taxed at rates equivalent to capital gains rates due to certain provisions in the Income Tax Act (ITA). Any growth in the value of the shares above the FMV at the time of withdrawal from the DPSP will be taxed as capital gains.

There is a general averaging rule in the ITA that states that the adjusted cost base (ACB) of identical properties, which includes shares, must be averaged amongst all of

If you receive a single payment out of a DPSP as a complete withdrawal from the plan and the payment includes shares of your employer corporation or shares of a corporation with which your employer does not deal at arm's length (collectively referred to as the "employer shares"), you have another option. This article refers to this option as the DPSP deferral election option.

1) The 2019 Federal budget proposed a new type of retirement investment to promote greater flexibility in retirement. This new investment type is called an advanced life deferred annuity (ALDA). An ALDA will be a life annuity, the commencement of which may be deferred until the end of the year in which the annuitant attains 85 years of age. If approved, this could provide another investment option in retirement for DPSPs and a deferral of tax on the ALDA portion post-age 71.

the identical properties you hold at that time. However, this rule does not apply to shares that are subject to the DPSP deferral election. So, if you also hold shares of your employer, for example, that you purchased yourself in your non-registered account, the ACB of your shares subject to the DPSP deferral election do not have to be averaged with your other shares. In addition, if you dispose of some, but not all, of your employer shares, you will be deemed to dispose of the shares that are not subject to the DPSP deferral election first. This allows you to continue deferring the tax on the growth that accrued while the shares were in the DPSP, where you are still holding some of your shares.

An example

Let's look at an example assuming the following facts:

- As an employee, you receive a single payment from the DPSP that includes shares of your employer corporation.
- The cost of the employer's shares to the DPSP is $10,000.
- The FMV of the shares at the time of complete withdrawal from the plan is $30,000.
- The FMV of the shares at the time of disposition is $60,000.
- Your marginal tax rate is 50% at all times.

Under normal circumstances, if you transferred all of the shares in-kind out of the DPSP to a non-registered plan, you would have to include in income the FMV of the shares at the time of withdrawal and pay tax of $15,000 ($30,000 x 50%). However, if you terminated your interest in the DPSP and made a tax election using CRA Form T2078, you can transfer your employer's shares in-kind from the DPSP to your non-registered account and instead only include in income the cost of the shares to the DPSP, which is $10,000. Your tax at the time of withdrawal would be $5,000 ($10,000 x 50%). The tax on the remaining $20,000 ($30,000 – $10,000) would be deferred until you disposed of the shares or are deemed to dispose of them.

When you later dispose of the shares in your non-registered account for $60,000, you will have to first include the deferred $20,000 as ordinary income on your tax return. One half of this income inclusion, or $10,000, can be claimed as a tax deduction due to certain provisions in the ITA. As a result, the net amount of $10,000 is taxed at your marginal rate of 50% resulting in a tax of $5,000. In addition, the growth in the value of the shares after they were withdrawn from the DPSP will result in a capital gain, which is only 50% taxable. In this example, the capital gain would be $30,000 ($60,000 – $30,000), the taxable capital gain would be $15,000 ($30,000 x 50%) and the resulting tax would be $7,500 ($15,000 x 50%).

The main benefit of the DPSP deferral election is that the increase in the value of the shares while they were held in the DPSP is taxed at half your marginal tax rate instead of at your full marginal tax rate.

Here's a summary of the taxes:

Taxable event	Amount	Taxable amount	Tax at 50%
Withdrawal from DPSP:			
Ordinary income	$10,000	$10,000	$5,000
Disposition of shares:			
Ordinary income	$20,000		
Deduction	($10,000)		
		$10,000	$5,000
Capital gain	$30,000		
Taxable capital gain		$15,000	$7,500
Total tax			**$17,500**

The main benefit of the DPSP deferral election is that the increase in the value of the shares while they were held in the DPSP is taxed at half your marginal tax rate instead of at your full marginal tax rate.

There is an additional benefit of the deferral election option which is not reflected in our example. Where an employee has made a DPSP deferral election with respect to employer shares, there is a rule in the ITA that declares the cost to an employee of employer shares distributed by a DPSP to be an "eligible amount". An eligible amount is included in the calculation of the maximum deduction available in respect of RRSP contribution room. In our example, this would allow you to make an additional $10,000 RRSP contribution, from a source other than the employer shares. The benefit of making the RRSP contribution, when you make the DPSP deferral election, is that no tax would be payable in the year with respect to the employer shares received from the DPSP. This is because the $10,000 income inclusion in the year you withdraw the employer shares from the DPSP can

be offset by making a $10,000 RRSP contribution and claiming a deduction. This benefit defers the tax until you eventually withdraw the $10,000 from your RRSP or RRIF. In addition, the $10,000 can grow tax-deferred in your RRSP until that time.

If you do not have a source of funds, other than your employer shares, with which to make an RRSP contribution, you will have to pay tax on the cost amount of the shares to the DPSP in the year of withdrawal. The downside of this, when comparing it to an alternative option such as directly transferring the shares to your RRSP, is that you will be prepaying tax on the $10,000 cost amount of the shares.

A comparison

For illustrative purposes, let’s compare the tax implications of the deferral election option (where you are not able to contribute an additional $10,000 to your RRSP) to directly transferring the shares on a tax-deferred basis to your RRSP. If the shares were transferred directly to your RRSP, there would be no tax payable at the time you withdraw from the DPSP. But, later when you withdraw amounts from your RRSP, the withdrawals will be fully taxable.

Using the same facts as the previous example, and assuming that the sale proceeds when you eventually dispose of the shares will be withdrawn from the RRSP, the tax you would pay in the year of disposition and withdrawal from the RRSP is $30,000 ($60,000 x 50%). This illustrates that you could save $12,500 in taxes by using the DPSP deferral election option.

Just a reminder that the DPSP deferral election only applies to shares of your employer corporation or the shares of a corporation with which your employer does not deal at arm’s length. So if your plan includes other investments, you should consider the tax implications on withdrawing the other investments. To defer the tax, a good alternative may be to transfer any other property directly to your RRSP.

Options on death

If you pass away having vested funds in a DPSP, these funds must become payable to your designated beneficiary or your estate no later than 90 days after your death. If you reached age 71 in the year of death and passed away after October 2, then the vested funds in your DPSP must become payable by December 31 of that year.

If you pass away having vested funds in a DPSP, these funds must become payable to your designated beneficiary or your estate no later than 90 days after your death.

Payments from a DPSP are generally taxable to the recipient, either your designated beneficiary or your estate, when received. However, if your designated beneficiary or the person entitled to your DPSP under your estate is your spouse or common-law partner, the payment from your DPSP can be rolled over on a tax-deferred basis to their RRSP, RRIF, DPSP, RPP, PRPP or SPP. They are able to rollover the payment without any impact on their RRSP contribution room. The DPSP deferral election is also an available option on death, where the conditions to make the election are met.

Conclusion

These plans allow you to share in the profits of your employer and defer paying tax until you start receiving the funds from the DPSP. However, your employer contributions to the DPSP will affect your RRSP contribution room for the following year, so it’s important to consider this when making your RRSP contributions. It’s also important to understand the specific features of your DPSP. Speak with your plan provider to find out the details of your plan.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the “Companies”) and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. “RBC advisor” refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ®/™ Registered trademarks of Royal Bank of Canada. Used under licence. © 2020 Royal Bank of Canada. All rights reserved. NAV0039 (07/20)