



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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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 can't 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're in a DPSP, but they're included in your income for tax purposes when withdrawn.

DPSP contributions made on your behalf will increase your pension adjustment (PA). The PA you accrue in a year will reduce your RRSP contribution room for the following year. A PA represents the value of the benefits you earn under your employer's DPSP and RPP. The PA is reported to you on your T4, *Statement of Remuneration Paid*, slip.

Qualified investments

Qualified investments for a DPSP are similar to those for an RRSP. A DPSP can't invest in bonds, debentures, notes, bankers' acceptances or similar debt obligations of the employer that's making contributions to the plan. Unlike RPPs, DPSPs don't have a limit on the percentage of shares of any one company 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've 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 amount of the lump sum taken for the year and are

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the same rates that apply to RRSP withdrawals. The lump-sum withdrawal from your DPSP will be subject to the following withholding tax rates:

- 10% (19% for Quebec) on amounts up to and including \$5,000
- 20% (24% for Quebec) on amounts over \$5,000, up to and including \$15,000
- 30% (29% for Quebec) on amounts over \$15,000

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 age 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 haven't 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. 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.

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 (that's not an advanced life deferred annuity (ALDA)) from an insurance company, as long as the annuity begins by December 31 of the year you turn age 71 and, if it has a guaranteed term, such a term must not be more than 15 years. 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 doesn't 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 directly transfer an amount that's not part of a series of periodic payments on a tax-deferred basis to an ALDA of which you are the annuitant.
- 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 that contributed to the DPSP (your "employer corporation"), or shares of a corporation with which your employer doesn't 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 doesn't 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'd 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

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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; 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'll 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's 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 the identical properties you hold at that time. However, this rule doesn't apply to shares 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 don't have to be averaged with your other shares. In addition, if you dispose of some, but not all, of your employer shares, you'll be deemed to dispose of the shares that aren't 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're still holding some of your shares.

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.

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, RRI, DPSP, RPP, PRPP or SPP. They are able to roll over 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

A DPSP is a registered plan sponsored by your employer that helps you save for retirement through tax-deferred growth. 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, participation

in a DPSP will affect your RRSP contribution room, 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.

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