Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Retirement Compensation Arrangement

A Retirement Compensation Arrangement (RCA) can be an effective retirement planning tool for high income earners. It may be more flexible than Registered Retirement Savings Plans (RRSPs) and Registered Pension Plans (RPPs). RRSPs and RPPs are subject to contribution limits that may not provide you with sufficient retirement income in the future. RCAs instead have the potential of providing you with more income in your retirement years. For business owners and professionals, RCAs can be used to supplement RPP benefits and other savings to better ensure that you maintain your standard of living once you withdraw from active employment. An RCA should be considered in the context of your overall retirement, taxation and estate planning.

This article may outline strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax 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 legal and/or tax advisor before acting on any of the information in this article.

What is an RCA?

An RCA is a plan or arrangement under which an employer, former employer or, in some cases, an employee makes contributions to a custodian. The custodian holds the funds in trust with the intent to eventually distribute the funds to the employee (beneficiary) upon retirement, loss of office or loss of employment, or any substantial change in the service the employee provides.

As a trust, there is a written agreement setting out the terms of the trust, such as information about the powers of the custodian, investment of the trust funds, responsibilities, rights and limitations

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of the parties and resignation, removal and replacement of the custodian, etc.

Why an RCA?

An employer can use an RCA to “super-size” a pension plan. This is because there is no arbitrary upper limit on the amounts that you or your employer can contribute to the plan, provided that the amounts contributed are “reasonable” (see discussion in the section, “Reasonable Contributions”). An RCA can provide you with supplemental pension benefits so that you may maintain your standard of living in retirement. Typically, an RCA is part of a retirement plan, which may also include a Registered Pension Plan (RPP) or an Individual Pension Plan (IPP) set-up by the employer. An RCA may also provide pension benefits to employees when a company does not have an RPP.

Advantages of an RCA

- RCA contributions do not affect RPP contributions; however, RPP/ IPP contributions may reduce the amount that can be contributed to an RCA since contributions to an RCA have to be reasonable taking into account the total retirement package.
- Employer or employee contributions to an RCA do not affect RRSPs as they don’t generate a pension adjustment (PA).
- A contribution to an RCA provides an immediate tax deduction to an employer. It 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.
- As an owner-manager, you may be able to use an RCA to reduce the purchase price of your business prior to the sale or transfer of your business, subject to the reasonability of the contributions.
- The company may use an RCA to fund severance payments. The full amount of the contribution is immediately deductible to the employer. The employee may receive the income in a later year or in installments.
- Upon death, proceeds from an RCA are not subject to probate fees if a beneficiary is named on the RCA agreement. If the estate is the named beneficiary, the RCA proceeds may require probate.
- RCA contributions are exempt from payroll and healthcare taxes.
- RCAs may provide a level of protection from an employer’s creditors.

A contribution to an RCA provides an immediate tax deduction to an employer. It 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.

Disadvantages of an RCA

- Since contributions to an RCA and any income or realized capital gains in the RCA are subject to a refundable tax of 50%, the amount of funds available for investment is significantly less in the RCA than if the funds are left in the corporation to invest.
- The 50% refundable tax is credited to the Refundable Tax Account (RTA) which is a non-interest-bearing account.
- There are initial setup fees, and ongoing management and administration fees.
- The custodian will need to file a T3-RCA tax return each year, even if there has been no activity in the RCA trust in the year.

Taxation of an RCA

Contribution deductible

The employer can generally deduct 100% of their RCA contributions. There is no specific limit to the amount of contributions an employer can make to an RCA, as long as the amounts are “reasonable” (see discussion in the next section) and not excessive relative to the target retirement compensation to be provided.

The Income Tax Act (ITA) also allows tax-deductible contributions by the employee. However, employee contributions cannot exceed those of the employer and the employee must be required, under the terms of employment, to contribute to the RCA. Employee contributions will reduce the amount that may be contributed by the employer since total contributions to the RCA must be reasonable.

Reasonable contributions

The Canada Revenue Agency (CRA) may disallow the employer’s deduction for contributions to an RCA if the amount is not “reasonable”. The ITA does not define what is considered reasonable contributions to an RCA. The CRA may take the view that benefits are not reasonable if they are greater than benefits that would be appropriate for the employee's position, salary and service or where the

RCA does not take into account benefits that are provided through other registered plans, such as a registered pension plan. Instead, the RCA should provide a normal level of benefits which the CRA described as follows:

> "A normal level of benefits would be the same benefit provided under a 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 generally used for defined benefit pensions to be used for the purposes of determining RCA retirement benefits but ignoring the tax maximums imposed on defined benefit pension plans by the ITA. This continues to be CRA's position with respect to reasonable contributions to an RCA. A qualified actuary can help you determine a reasonable RCA contribution.

Refundable tax account

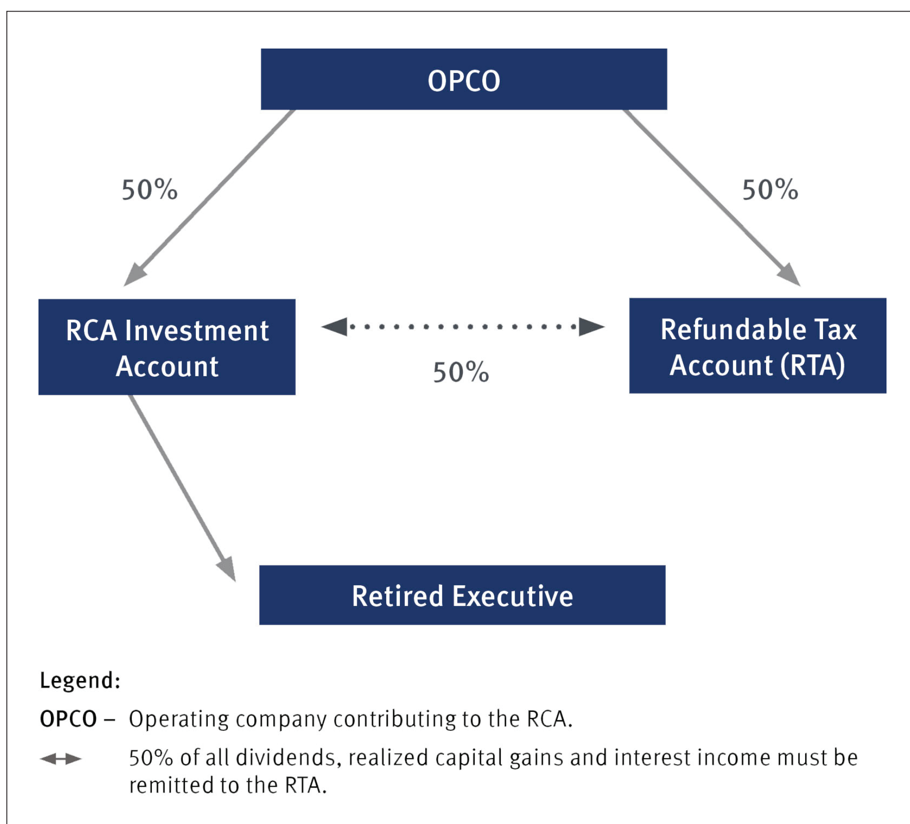
When a contribution is made to an RCA, only half of the contribution is deposited with the custodian of the RCA trust. The other half is deposited with the CRA into the RTA as a payment of the 50% refundable tax. The RTA is a non-interest-bearing account. It accumulates the refundable tax until distributions are made out of the RCA. When a distribution is made out of the RCA, the CRA will refund some of the tax to the RCA.

When the RCA makes distributions to the beneficiary $1 is refunded from the RTA to the RCA trust for every $2 distributed. It is possible to recover 100% of the RTA balance if the RCA is completely paid out to the beneficiary.

In addition, 50% of all income earned and capital gains realized in the RCA trust must be remitted to the RTA on an annual basis. Unlike investment income earned in a personal non-registered investment account or regular trust account, Canadian dividends and capital gains do not receive preferential tax treatment in an RCA. In other words, the entire capital gain is subject to the 50% refundable tax and the RCA does not receive a dividend tax credit on taxable Canadian dividends.

When the RCA makes distributions to the beneficiary $1 is refunded from the RTA to the RCA trust for every $2 distributed. It is possible to recover 100% of the RTA balance if the RCA is completely paid out to the beneficiary.

Below is an illustration of how the RTA is incorporated in the structure of the RCA:



Distributions from an RCA

All distributions out of an RCA trust are fully taxable and subject to withholding tax at source. The RCA custodian has to provide you with a T4A-RCA slip, Statement of Distributions from a Retirement Compensation Arrangement (RCA), showing the amount of distributions and the income tax deducted. You have to report the RCA income as "other income" on your income tax return in the year it is received. It is taxable at your marginal tax rate.

Pension income splitting

In some cases, you may be able to split your RCA income with a spouse. The following conditions must be met:

- The RCA beneficiary must be at least 65 years of age
- The RCA payments must be in the form of life annuity payments and be supplemental to benefits received out of a RPP

The RCA payments that are eligible for pension income splitting are subject to a limit. The limit is calculated as the "defined benefit limit" ($2,914.44 for 2017) multiplied by 35, minus your other eligible pension income. If the calculated amount is greater than your actual RCA payments then you are limited to your actual RCA payments. The "defined benefit limit" changes annually and can be found on CRA's website.

Speak with a qualified tax advisor to determine whether your RCA income is eligible for pension income splitting with your spouse.

Termination of RCA or death of beneficiary

The custodian holds the RCA funds with the intent of eventually distributing them to the employee, former employee or other beneficiary on or after an employee's retirement, loss of an office or employment or any substantial change in the services the employee provides. When one of these triggering events occurs, depending on the design of the RCA plan, distributions can be made either periodically or in a lump-sum. RCAs are generally more flexible than registered pension plans and other types of registered plans in terms of when and how much can be paid out of the plan to the beneficiary. For example, you do not necessarily have to start taking payments out of an RCA when you turn a certain age especially if you are still working for your employer and there has not been a substantial change in the services you provide to them. Compare this to a registered pension plan or an RRSP which must start an income stream to the plan member or annuitant after the year in which they turn 71.

Examples of some situations where the RCA may be terminated, in accordance with the RCA agreement, is when you sell your business before your planned retirement age and your business sponsored an RCA for you, if you leave Canada to a low or no tax jurisdiction or in the event of death of the RCA beneficiary. Of course, the beneficiary is taxed as funds are distributed, and the RCA receives the refundable tax from the CRA at that time. If you decide to wind up the RCA, and the RCA agreement allows for early termination, the whole RTA may be refunded to the RCA plan.

> Generally Canadian residents, that are non-U.S. persons, are only subject to U.S. estate tax on death on their U.S. situs assets. U.S. assets held in an RCA could potentially be included as the RCA member's U.S. situs assets on death for the purposes of calculating their U.S. estate tax liability, depending on the design and terms of the RCA.

The entitlement to the RCA benefits on the death of the plan member is determined by the terms of the RCA agreement. The sponsoring company may impose certain terms and conditions which will vary by plan. For example, if the plan designates the spouse as the beneficiary after the death of the RCA member, the RCA benefits may be transferred to the member's surviving spouse on a tax-deferred basis. In this case, the surviving spouse will be taxable on distributions made to them from the RCA in the year the distributions are received. If there is no surviving spouse, the plan member's RCA entitlement may have to be included as income on their final return (or on a "right or thing" return). The RCA benefits can then be distributed to the deceased's estate.

The terms of an RCA agreement dealing with the death of the RCA member are not specifically restricted or governed by law. The terms can be determined by negotiation between the RCA member and their employer. Therefore, it is important to consult with a qualified tax and/ or legal advisor to understand the RCA benefits at death and the tax implications.

Non-resident tax treatment

The plan administrator may withhold 25% when making payments to a non-resident beneficiary. However, if the payments qualify as "periodic pension payments" the withholding tax rate may be reduced if the beneficiary is a resident in a country that has a tax treaty with Canada and the treaty allows for a reduced rate. Distributions from an RCA will be considered "periodic pension

payments" as long as the total payments in the year do not exceed a certain dollar limit.

The tax treatment of RCA income and RCA payments in the beneficiary's country of residence depends on their local tax rules. If you do not live in Canada and you are the beneficiary of an RCA, speak with a qualified tax advisor in your country of residence for more information.

There are special planning considerations when setting up an RCA for a Canadian resident that is also a U.S. person (U.S. citizen or green card holder). If you are a U.S. person, speak to a qualified cross-border tax advisor.

U.S. estate tax

Generally Canadian residents, that are non-U.S. persons, are only subject to U.S. estate tax on death on their U.S. situs assets. U.S. assets held in an RCA could potentially be included as the RCA member's U.S. situs assets on death for the purposes of calculating their U.S. estate tax liability, depending on the design and terms of the RCA. You should consult with a qualified Canada/U.S. cross-border tax advisor to determine whether your U.S. assets held in your RCA would be included as part of your estate for U.S. estate tax purposes.

> If you are a business owner, you may want to consider using an RCA to reward long-term employees and retain top executives.

Conclusion

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

- If you are a business owner, you may want to consider using an RCA to reward long-term employees and retain top executives. An RCA contract provides flexibility in setting the terms of payment and participation.
- If you are an owner manager contemplating moving and retiring outside Canada, in a lower tax jurisdiction, or in a province with a lower tax rate, you may want to consider using an RCA. Setting up an RCA in this case may allow you to reduce your personal taxes ultimately paid in retirement in the lower tax jurisdiction.
- If you plan to sell your business, you may want to consider setting up an RCA to reduce the value of your business hence the resulting

Please consult with a qualified tax and/or legal advisor when contemplating any of the strategies discussed in this article.

Wealth Management

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