Personal Tax Planning

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FUNDING SUPPLEMENTAL RETIREMENT PLANS

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The purpose of this article is to examine possible ways in which supplemental retirement plans can be arranged, to comment on the income tax implications associated with such arrangements, and to evaluate possible methods for funding such plans in a tax-effective manner with the use of a retirement compensation arrangement (RCA). In addressing the issue of funding supplemental retirement plans, any discussion relating to plans that are not RCAs has, for the most part, been deliberately avoided.

RETIREMENT BENEFITS

The Income Tax Act[1] allows employers to deduct contributions to registered pension plans (RPPs), but only within certain limits. In the past, Revenue Canada reserved the right to register only those pension plans that fit the administrative profile laid out in *Information Circular* 72-13R8[2] (and its many predecessors).

With the passage of Bill C-52,[3] the government has now formally prescribed the registration requirements for RPPs.[4] A review of these requirements is beyond the scope of the present discussion;[5] however, the new rules

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[1] RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

[2] *Information Circular* 72-13R8, "Employees' Pension Plans," December 16, 1988.

[3] Bill C-52, An Act To Amend the Income Tax Act and Related Acts, passed by the House of Commons June 14, 1990; SC 1990, c. 35; given royal assent June 27, 1990.

[4] Subsection 147.1(2) and draft regulation 8300, issued December 11, 1989.

[5] See, for example, Hugh A. Gordon, "Deferred Compensation," in *Report of Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 34:1-30; Barrie M. Philp, "Executive and Employee Compensation After Tax Reform," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 28:1-56; and Philip Friedlan and Wayne Beach, "Selected Aspects of Deferred Compensation and Deferred Income Plans," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 31:1-33.

lend impetus to the formation of supplemental retirement plans for senior executives, particularly for those who wish to maintain the style of living that they enjoy as salaried employees.

The new legislation confirms to Canadians the level of support the treasury will provide in assisting the accumulation of tax-deferred savings for retirement. The intent behind the rules governing retirement savings is to provide a uniform limit on tax-assisted savings to all Canadians, whether they are members of employer-sponsored pension plans or profit-sharing plans, or save on their own through registered retirement savings plans (RRSPs).[6]

In the case of defined benefit pension plans, the maximum benefit that can be provided by a registered plan is approximately $1,722 per year of service (indexed for inflation after 1994).[7] Plans providing richer benefits will not qualify for registration. In the case of money purchase pension plans, once the new system matures, limitations on deductibility will match the annual limits available under the RRSP rules. As a result, members of defined benefit RPPs will receive no more than approximately $60,000 in retirement income assuming that they have worked for, say, 35 years. Since the benefit per year of service will be indexed for inflation, executives should think of the $60,000 in terms of real purchasing power, keeping in mind that this is a pre-tax amount. On the basis of current income tax rates, an annual pension income of $60,000 to a single retiree in Ontario (receiving maximum Canada pension plan and old age security payments) would provide annual disposable income of approximately $46,000.

To an executive currently earning (and spending) well in excess of $60,000 annually and wishing to secure a comfortable post-retirement income and lifestyle, a supplemental retirement plan is a necessary and prudent component of any comprehensive retirement plan.

SUPPLEMENTAL RETIREMENT PLANS

Plans that could be conceived as providing supplemental retirement benefits vary widely from mere promises to fully funded arrangements. Whatever the form of the arrangement between the employer and the executive, the income tax considerations must be explored to determine the effectiveness of the plan in achieving the objectives of both parties. The experience of the last decade has shown us that the effectiveness of the arrangement should be continually re-examined in the light of any changes in income tax and other laws that may be applicable.[8]

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[6] Canada, Department of Finance, *Information*, no. 89-132, December 11, 1989.

[7] Draft regulation 8302.

[8] As an example, prior to the introduction of the RCA rules, some employers acquired life insurance policies on employees covered by an unfunded non-statutory pension plan. The employer as beneficiary under the life insurance policy was in a position essentially to fund the employee's retirement benefits from policy loans. This opportunity is presumably what led to the introduction of subsection 207.6(2) and the harsh grandfathering that applies to pre-October 9, 1986 arrangements.

From the employer's point of view, there is a preference not to fund the arrangement; however, pension legislation in a particular province may preclude that option. Where funding is required, the employer's objective is to maximize tax-deferred growth on any funding provided. From the executive's point of view, there is a desire to remove any uncertainty with respect to the employer's ability to meet the commitment, without jeopardizing relations with the employer. And finally, the Department of Finance prefers that there be no mismatch between the employer's deduction for the cost of meeting the commitment and the taxation of the ultimate benefits derived by the employee under the arrangement.

A prudent planner will have to decide what sort of arrangement will provide the appropriate level of security, assuming an acceptable level of risk. It is up to the executive to determine whether a particular arrangement entered into will achieve his retirement objectives.

Parallel Benefit Plans

The most common supplemental retirement arrangement is simply to provide senior executives with an unregistered plan with features that are the same as or similar to those of the registered plan available to all employees. The only significant difference would be that the unregistered plan would provide for richer benefits than those allowed under the RPP. A senior executive might be a member of both plans, or not a member of the RPP in order to be able to manage his own tax-deferred savings through an RRSP.

Theoretically, parallel benefit plans may be funded or unfunded; however, funding may be required by provincial pension benefit legislation. In jurisdictions where funding is optional (or not enforced), the employer faces a business decision in terms of whether, how, and when to fund the arrangement. This decision will be based largely on the employer's ability to meet the commitments under the plan as they become due. Provided that the employer will be in a position to meet these commitments, it should make no difference to the employee whether and how the employer chooses to fund the arrangement.

Retiring Allowances

Retiring allowances can be a useful means of providing supplemental income or capital on retirement. Retiring allowances may qualify for a limited rollover to an RRSP; however, at a maximum rollover of $2,000 per year of service ($3,500 for years prior to 1989 where the employee was not a member of an RPP under which benefits had vested),[9] the rollover is of small consequence in providing for supplemental retirement benefits in the order of those required for senior executives.

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[9] Paragraph 60(j.1).

Foreign Pension Plans

With the increasing international mobility of senior executives, foreign-based pension plans may grow in importance as a source of supplemental retirement income for senior executives, particularly those intent on becoming non-resident on retirement and those who are resident in Canada for less than five years.[10]

Consulting Contracts and Directorships

Consulting contracts and directorships can be a useful means of providing executives with supplemental retirement income, although the very nature of such arrangements seems to preclude conventional retirement. Both arrangements, however, contain an element of uncertainty. In the case of directorships, directors are ordinarily appointed at the discretion of the shareholders; accordingly, there is no assurance that the planned appointment will materialize. Similarly, any intended consulting arrangement will depend on the continued existence of the employer and/or the existence of a need for the services of the former executive.

Stock-Based and Phantom Stock Plans

Stock-based plans, whether provided through stock options or through stock ownership or phantom stock plans,[11] are more useful in providing a performance incentive to senior executives than in providing for supplemental retirement income. The vagaries and unpredictability of the stock market have shown that such plans are not well suited to providing supplemental retirement benefits. Currently, because of the generally depressed state of the stock market, leveraged stock plans in particular are proving not to be a guarantee of a secure and happy retirement.

No matter what the form of the retirement arrangement, any steps taken to pre-fund the arrangement will result in the possible application of the RCA rules (part XI.3 tax and the related compliance burden). Under the RCA rules, any tax-deferred accumulation of capital can be seriously hampered. However, executives will generally accept the burdens associated with an RCA in the hope of securing the promised benefits.

RETIREMENT COMPENSATION ARRANGEMENTS

The rules respecting RCAs were introduced along with the Department of Finance's October 9, 1986 notice of ways and means motion relating to

[10] The Canadian income tax implications of using these arrangements to provide supplemental retirement benefits are addressed in Friedlan and Beach, supra footnote 5, at 31:13-15.

[11] "Phantom stock plan" is the term used for certain compensation arrangements under which the amount of remuneration (typically paid as a bonus) is linked to increases in the value of notional shares of an employer. Concern has often been raised about whether such plans constitute salary deferral arrangements (SDAs). Proposed regulation 6801(4) clarifies conditions under which such a plan will not be considered an SDA. This does not, however, mean that plans that do not fit the exemption are, by process of elimination, SDAs.

retirement savings.[12] Unlike the majority of the rules relating to retirement savings, which were delayed many times before at last receiving royal assent on June 27, 1990, the RCA rules became effective immediately, with limited grandfathering for existing arrangements.

The RCA rules were designed to block the proliferation of funded non-statutory pension and superannuation plans, particularly by non-taxable entities. The rules were required to ensure that taxpayers were not in a position to gain an advantage from the tax system over and above the tax assistance provided through statutory arrangements, RPPs, DPSPs, and RRSPs.

The rules governing RCAs are contained mainly in part XI.3 of the Act, although the definition of what constitutes an RCA is set out in subsection 248(1). An RCA is generally defined to include a plan or arrangement under which contributions are made by an employer of a taxpayer to another person (the custodian), in connection with benefits that are to be or may be received or enjoyed by any person on, after, or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the taxpayer, or severance of the taxpayer's employment.

Statutory plans and health-related benefit plans are excluded from the RCA rules, as well as arrangements that are salary deferral arrangements (SDAs).[13] Plans that are maintained primarily for the benefit of non-residents in respect of foreign service also are excluded; however, such plans may fall under the employee benefit plan (EBP) rules.[14] Provision exists for the minister of finance to prescribe plans that are not caught by the RCA rules. Draft regulation 6802 prescribes plans under the Canada Pension Plan and the Unemployment Insurance Act, and certain salary deferral plans for National Hockey League referees.

As indicated above, the person receiving an RCA contribution is referred to as the custodian. Special reporting and withholding requirements are placed on any person who is a custodian under such an arrangement.[15] Contributions to an RCA exclude payments made to acquire an interest in a

[12] See Canada, Department of Finance, *A Better Pension System: Saving for Retirement—Improved Tax Treatment: Detailed Rules and Procedures* (Ottawa: the department, October 1986); and Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, October 9, 1986.

[13] A salary deferral arrangement is quite different from an RCA. The SDA provision (subsection 248(1)) is an anti-avoidance rule designed to discourage taxpayers from entering into arrangements to defer the receipt of what would otherwise be salary or wages for services already rendered. As defined, an SDA is not an arrangement that a taxpayer can plan to enter into. In order for an arrangement to be an SDA, one of its main purposes must be to postpone tax payable on a right to current employment income. Presumably, where an employee entered into an arrangement with the intent of accelerating an income inclusion, it would be difficult to argue that one of the main purposes of the arrangement was to postpone tax payable.

[14] "Employee benefit plan" is defined in subsection 248(1).

[15] A custodian must withhold taxes on distributions, report distributions on prescribed forms, and file an annual return to report the amount of the refundable taxes in respect of the arrangement.

life insurance policy. However, where a contribution is made to an RCA trust and the proceeds are used by the custodian to pay a premium on a life insurance policy, the general RCA rules will apply. The use of life insurance in connection with an RCA is discussed later in this feature.[16]

Where a particular person holds property in trust under an arrangement that, if the property were held by another person, would be an RCA, the arrangement is deemed to be an RCA, of which the particular person is the custodian.

The rules apply to plans that are not necessarily pension or superannuation plans, but also to funded retiring allowances. Funded deferred compensation plans would in most cases be caught by the anti-avoidance rules governing SDAs; however, where the purpose test in the SDA definition[17] is not met, the RCA rules may apply. If neither the SDA nor the RCA rules apply, the EBP rules will apply.

Where a trust results from the existence or establishment of an RCA, such a trust is referred to as an RCA trust.[18] An RCA trust is not subject to income tax under part I,[19] but rather is subject to a 50 percent refundable tax on contributions made to and certain income earned or realized by the RCA trust.[20] Tax is refunded to the RCA trust as taxable distributions are made by it.[21] Where property is held in connection with the arrangement, but not held by a trust governed by the arrangement, for the purposes of part I and the RCA rules, an inter vivos trust is deemed to exist with respect to the subject property, the trust is deemed to own the property, and the custodian of the arrangement is deemed to be the trustee.[22]

The subject property of an RCA is defined to mean property that is held in connection with the arrangement.[23] There are no restrictions on the type of property that may be held by an RCA trust or held in connection with an RCA.[24] In structuring transactions with the RCA trust, care must be taken to

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[16] An excellent review of issues involved in the use of insurance products in funding compensation arrangements is presented by William D. Hawley, "Insurance-Related Compensation Arrangements," in the 1989 Conference Report, supra footnote 5, at 32:1-18.

[17] See subsection 248(1).

[18] Subsection 207.5(1).

[19] Paragraph 149(1)(q.1).

[20] Subsection 207.7(1).

[21] Subsection 207.7(2).

[22] Subsection 207.6(1).

[23] Subsection 207.5(1).

[24] Since the arrangements are designed to be more or less tax-neutral vis-à-vis taxable entities, there appears to be little reason to regulate the type of investments that an RCA trust can hold. However, as more sophisticated uses of the RCA rules are developed, restrictions may well be imposed. It is interesting to note that the 50 percent rate was established at a time when top corporate income tax rates were generally higher than 50 percent. The 1987 tax reform reduced the corporate tax rates but provided for no corresponding reduction in the RCA rate.

transact with the trust at fair market value. Special rules apply where a trust governed by an RCA

- disposes of property to a person for consideration that is less than the fair market value of the property, or for no consideration;
- acquires property from a person for consideration that is greater than fair market value; or
- permits a person to use or enjoy property of the trust for no consideration or for consideration that is less than the value of such use.

Such circumstances will result in an income inclusion to the person acquiring, disposing of, or using the property.[25]

Tax is payable by, or refundable to, the RCA trust in respect of year-over-year changes in the refundable tax of the RCA.[26] The refundable tax is essentially the amount of tax paid by the RCA trust over its duration. The balance of refundable tax[27] is the amount, if any, by which the aggregate of

1) 50 percent of all contributions made under the arrangement and

2) 50 percent of the amount, if any, by which

a) income from a business or property (ignoring the dividend gross-up) and capital gains

exceed

b) losses from a business or property and capital losses

exceeds

3) distributions, including distributions taxed in the hands of the employer.

Where a plan or arrangement comes within the definition of an RCA, understanding the components of the refundable tax will assist a custodian in efforts to maximize the after-tax investment yield by the RCA trust and therefore minimize the level of funding required to meet any obligations under a supplemental retirement arrangement.

Contributions

The deduction of contributions made by an employer under an RCA is specifically precluded with the exception of contributions in respect of services rendered by an employee or former employee.[28] In structuring contributions to an RCA, it is important to be mindful of who the employer is,

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[25] Subsection 56(11) will deem an amount to have been received by the person. Amounts received by a taxpayer from an RCA are included in income under paragraph 12(1)(n.3), 56(1)(x), or 56(1)(z).

[26] Subsection 207.6(5).

[27] Defined in subsection 207.5(1).

[28] Paragraphs 18(1)(o.2) and 20(1)(r).

and in which jurisdictions and on what sources of income the employer is taxable.[29]

An employer is not permitted a deduction for contributions that are paid as part of a series of payments and refunds of contributions under the arrangement.[30] In this regard, the Department of Finance must have been wary of schemes designed to accelerate employer deductions in one year and unwind the plan shortly thereafter, in order to gain the advantage of rate differentials. Without the foregoing rule, the RCA rules could be used as a "forward averaging" mechanism for corporations. Contributions that are unreasonable are not deductible by virtue of the general limitation in section 67.

An employee may deduct amounts contributed to an RCA[31] where

- the amount is paid to a custodian resident in Canada;
- the amount did not exceed amounts contributed to the plan by any other person in respect of the employee; and
- either the contribution was required by the employer's conditions of employment, or the plan to which the contribution was made was revoked and the contribution was made in accordance with the plan as last registered.

Contributions to an RCA are subject to a 50 percent withholding tax at source, which must be remitted to Revenue Canada on or before the fifteenth day of the month following the month in which the amount was withheld.[32]

The term "contribution" is not defined in the Act; however, it obviously requires some action on the part of the contributor to alter the beneficial ownership of the property being contributed. For example, the segregation or earmarking of property may constitute a contribution to an RCA where it results in a transfer of a beneficial interest in the property or some form of priority claim over the property by an employee or other party. Revenue Canada has stated in private interpretations that the setting up of a "book reserve" without an accompanying segregation of assets will not of itself create an RCA.

Revenue Canada has also indicated that the fair market value of a letter of credit will be considered a contribution to an RCA.[33] It is difficult to reconcile this position with the stated intention of the RCA rules, which is to eliminate the deferral of tax on unregistered pension and retirement

[29] It is important to know the jurisdiction and source of income for a taxable employer to gain maximum benefit from the tax deduction for the contribution. In addition, it is important to be aware of the employer since a taxpayer may deduct only contributions in respect of an employee or former employee.

[30] Paragraph 20(1)(r).

[31] Paragraph 8(1)(m.2).

[32] Paragraph 153(1)(p).

[33] "Revenue Canada Round Table," in the 1988 Conference Report, supra footnote 5, 53:1-188, question 29, at 53:46.

arrangements.[34] First, retirement income would in any event be deferred until retirement, provided that the amounts were not caught by the SDA rules. Second, a letter of credit does not facilitate a tax-deferred accumulation of capital as was originally available under the EBP rules which the RCA rules were designed to replace.

It is not clear what the fair market value of a letter of credit would be, or when the contribution would be considered to have been made. However, in private discussions, Revenue Canada's Rulings Directorate has indicated that a contribution would be considered to have been made at the time the letter of credit was issued. It appears that under Revenue Canada's interpretation, the amount of the contribution would be the cost to the employer of maintaining the letter of credit. In any event, the practical difficulties of obtaining a long-term letter of credit facility, as would be required in the case of a bona fide retirement plan, probably preclude its use except in unusual situations.

The use of a personal guarantee as security for a supplemental retirement arrangement will not result in a contribution to an RCA. This position was confirmed at the 1990 Revenue Canada round table,[35] although the department did not address the situation in which consideration is paid to obtain and maintain the guarantee. Like a letter of credit, a personal guarantee will not result in any tax-deferred capital appreciation over the life of the plan; further, the guarantee is only as good as the guarantor's ability to meet it at the relevant time.

A loan to an RCA generally would not be considered a contribution. Revenue Canada has indicated that an interest-free loan provided to fund the lag between distributions out of the plan and the ultimate refund of part XI.3 tax would not give rise to a taxable benefit under subsection 80.4(1).[36] Whether the department's position would differ if an interest-free loan were made to an RCA trust to allow the RCA trust to acquire property is not clear. Where a loan is granted to an RCA trust under which there are numerous beneficiaries, subsection 80.4(1) will be inoperative unless the loan is received or incurred in respect of a specific employee. Interest on a loan paid by the RCA trust will be deductible provided that it otherwise meets the tests for deductibility under paragraph 20(1)(c).

An employee borrowing to make a contribution to an RCA would not be entitled to a deduction for the interest cost relating to the borrowing by virtue of paragraph 18(11)(e).

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[34] Supra footnote 12.

[35] "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, forthcoming).

[36] Document obtained under the Access to Information Act, RSC 1985, c. A-1, as amended: letter dated August 22, 1989, originating division, Financial Industries. However, Revenue Canada cautions, as it normally does, that whether a loan is a contribution can be determined only after a detailed examination of all of the relevant terms and conditions in the specific situation.

The use of life insurance policies to provide funding for a supplemental retirement plan gives rise to special rules, discussed under a separate heading below.

Income

An RCA trust is subject to tax on the income or loss from a business or property, and capital gains or losses, being income computed under subdivision b and subdivision c, respectively, with the exception that the 25 percent dividend gross-up would be ignored in computing income under subdivision b.[37]

The mechanics of the computation effectively provide an indefinite carryforward of capital and non-capital losses. Net losses, however, cannot be used to shelter the tax payable on contributions to the RCA trust. The full amount of capital gains is subject to tax, as is the full amount of capital losses deductible. Capital losses are deductible without being restricted to the amount of capital gains, as they are under part I.

Other receipts that would not give rise to immediate taxation in an RCA trust include

- capital dividends, which may be available where an RCA owns shares in a private corporation that is in a position to pay a dividend on shares owned by the RCA trust (although if one of the main purposes of acquiring the share was to receive the capital dividend, subsection 83(2.1) would apply to recharacterize the capital dividend as a taxable dividend);
- capital reductions, which could be used to provide liquidity to an RCA trust; and
- certain private company stock dividends,[38] provided that only a nominal amount is added to the paid-up capital of the corporation that pays the dividend.[39]

Distributions

Distributions arise under the plan when funds are paid out to beneficiaries under the arrangement, including previously deducted amounts paid to the employer.[40] Where property of a trust governed by an RCA has been distrib-

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[37] Paragraph 207.5(1)(b).

[38] Where a stock dividend is paid on a share of a public corporation, part II.1 tax may be payable by the corporation. This potential tax liability would effectively preclude the use of low paid-up capital stock dividend shares of a public company as investments for an RCA.

[39] The amount of a stock dividend is included in income under subdivision b. "Amount" in relation to a stock dividend is defined in subsection 248(1) as the amount by which the paid-up capital of the corporation that paid the dividend is increased by reason of the payment of the dividend. Special rules apply to stock dividends on taxable preferred shares, term preferred shares owned by specified financial institutions, guaranteed preferred shares, and collateralized preferred shares; as a result, such dividends generally are unattractive to an RCA trust.

[40] Subsection 207.5(1).

uted by the trust to a taxpayer who was a beneficiary under the trust in satisfaction of all or any part of his interest, the trust is deemed to have disposed of the property for proceeds of disposition equal to its fair market value and to have paid to the taxpayer as a distribution an amount equal to that fair market value.[41]

Payments out of an RCA to residents of Canada are subject to the rates of withholding tax computed under regulation 102(1). Payments out of an RCA to employees, former employees, or their successors who at the time are non-residents of Canada are subject to a withholding tax at source of 25 percent pursuant to paragraph 212(1)(j).

Amounts received by an employer out of or under an RCA are included in computing income where the taxpayer, another person who carried on the business that was acquired by the taxpayer, or a non-arm's-length person contributed amounts that were deductible under paragraph 20(1)(r). Any excess over the employer's previously deductible contribution is included in the employer's income by virtue of paragraphs 56(1)(y) and 107.2(b). Since payments out of an RCA to an employer would be taxable, where such payments are contemplated or expected, consideration should be given to transferring an already taxable employer's interest in such a plan to a related corporation with existing shelter by way of an amalgamation or wind-up. This would enable the income to be received and sheltered by the loss company, and thereby would gain a deferral of tax on such income. Paragraph 87(2)(j.3) permits the flow-through of attributes of a predecessor corporation to an amalgamated corporation.

Caution must be exercised when transferring assets of a business that include an employer's interest in an RCA with an accrued gain. Any transaction entitling a taxpayer to proceeds of disposition of an interest in an RCA will result in an income inclusion to the vendor under paragraph 56(1)(y). In addition, the 50 percent withholding tax will apply to amounts paid on account of the purchase price.[42] The vendor will, however, be entitled to deduct the amount of previously deducted contributions to the plan, together with any amounts paid to acquire the interest in the RCA to the extent that amounts are included in his income from a disposition of the interest.[43]

Subject Property of an RCA

As noted earlier, the subject property of an RCA is defined in subsection 207.5(1) to mean property held in connection with the arrangement. The definition is relevant where the property held in connection with the arrangement is held, not by a trust governed by the arrangement, but by the employer or some other entity. How one distinguishes between property held in con-

[41] Paragraphs 107.2(a) and (b).

[42] Paragraph 153(1)(r).

[43] Paragraph 60(u).

nection with an arrangement and property held by a trust governed by the arrangement is important in determining the tax exigible on income earned by the RCA trust. As an example, assume that $100,000 is contributed by an employer to a custodian to be held in trust under an arrangement between the employer and an employee to provide retirement benefits in the future. An RCA trust would clearly exist, and the $100,000 would clearly be a contribution. If the trustee formed a corporation and subscribed for $100,000 of shares in the corporation, the shares would clearly be property held in connection with the arrangement. However, the more difficult question is whether the $100,000 held by the corporation would be property held in connection with the arrangement, so that a second RCA trust would be deemed to arise. Provided that there were no requirement for the corporation to hold particular property, it would be difficult for Revenue Canada to disregard the separate existence of the corporation. The importance of this distinction will become clear in the examples set out below under the heading "Funding Alternatives."

Life Insurance Policies

As indicated previously, the general definition of a contribution to an RCA excludes payments by the employer to acquire life insurance policies. Where an employer is obliged to provide benefits under a plan or arrangement similar to those contemplated by the general RCA definition and the employer (as opposed to the RCA custodian) acquires an interest in a life insurance policy that may reasonably be considered to have been acquired to fund such benefits (in whole or in part), special rules apply:[44]

- the person who acquired the interest (presumably the employer and beneficiary) is deemed to be the custodian of an RCA;

- the interest in the life insurance policy is deemed to be the subject property of an RCA;

- twice the amount of any premium paid in respect of the interest or any repayment of a policy loan thereunder is deemed to be a contribution to the RCA (and will attract the 50 percent tax); and

- payments received in respect of the interest, including any policy loans, are deemed to be distributions out of the RCA (and will recover a portion of the refundable tax).

Life insurance products are being specifically marketed as adjuncts to the funding of RCAs. Under typical arrangements, an employer establishes an RCA in respect of an employee (or group of employees). The employer either funds the life insurance policy itself or makes a payment to the RCA trust from which a premium is paid to fund a life insurance policy on the employee with the employer as the beneficiary.

The life insurance premiums continue to be funded through the employer's annual contribution until the cash surrender value of the policy is sufficient to be drawn against to carry the premiums required under the policy.

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[44] Subsection 207.6(2).

When the time comes to pay the employee's retirement benefits, the cash surrender value of the policy is used, together with the accumulated refundable tax account, to pay the benefits under the retirement plan.

For income tax purposes, a policy loan, defined in paragraph 148(9)(e) to mean an amount advanced by an insurer to a policyholder, is considered to be a disposition of an interest in a life insurance policy. Subsection 148(1) includes in a policyholder's income the amount, if any, by which the proceeds of disposition of an interest in the policy exceed the adjusted cost base of the interest immediately before the disposition. Amounts required to be included in computing income under subsection 148(1) are included in income under subdivision d, as income in respect of the disposition of a life insurance policy rather than income from property or a capital gain; accordingly, such amounts are not subject to the 50 percent tax under part XI.3.

The pre-tax yield available on a life insurance policy is, in most cases, comparable to guaranteed investment certificate rates offered by other financial institutions, the primary difference being that the yield inherent in an exempt policy is not subject to current taxation. The magic (if not the myth) of using life insurance to fund an RCA lies in the ability to accumulate a cash surrender value on a tax-deferred basis, then draw down on the cash surrender value under the policy without being subject to immediate taxation. The same effect could be achieved, in most cases at a lower cost to the employer, by simply providing the employee with sufficient after-tax funds to acquire personally an interest in a life insurance policy to fund a retirement benefit, although this would not provide the employer with any certainty that the policy would be used as intended.

FUNDING ALTERNATIVES

In most cases, arrangements for funding a supplemental retirement plan must comply with the RCA rules. However, such compliance need not be tax-inefficient, despite the 50 percent tax. The tax, after all, is refundable, and contributions are tax-deductible.

The discussion below reviews some possible arrangements for funding supplemental retirement income for a senior executive without the use of insurance. In each case, for ease of illustration, the aim of the plan is to provide a flat $100,000 retiring allowance payable on retirement in 10 years. For comparative purposes, full funding from the outset is assumed, although it is more likely that the funding contribution would be made over time. Unless otherwise stated, an assumed investment rate of 10 percent has been applied.

Naturally, the principles underlying each of the possibilities should be reviewed in the context of a particular situation, from the viewpoint of both the employer and the employee. Consideration also should be given to whether the general anti-avoidance rule[45] might apply in the light of the particular facts of a given situation.

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[45] Subsection 245.

Cash Contribution

In order to pre-fund the $100,000 retiring allowance with a cash contribution,[46] $61,392 would have to be contributed to the RCA trust in year 1. As a result, $30,696 would be withheld and forwarded to Revenue Canada and the remainder would be available for investment by the RCA trust. Assuming that the RCA trust could invest the funds at 10 percent, the following would be the result:

Year	*Contribution (distribution)*	*Income @ 10 %*	*RCA tax (refund)*
1	$ 61,392	$3,070	$32,231
2		3,223	1,611
3		3,384	1,692
4		3,553	1,776
5		3,731	1,866
6		3,918	1,959
7		4,113	2,057
8		4,319	2,160
9		4,535	2,267
10	(100,000)	4,762	(47,619)

In the above example, the employer would have an after-tax cost of approximately $34,380 in year 1, assuming a 44 percent corporate income tax rate; the employee would receive $55,000 in year 10, assuming a personal tax rate of 45 percent.

Immediate Salary

Since the employee's marginal income tax rate will be lower than the 50 percent tax applicable to an RCA trust, the employer can realize a saving over the RCA alternative by simply paying the employee $58,540 in additional salary today, which—assuming a 45 percent personal tax rate—would result in after-tax cash of $32,200 available for investment. Assuming that the latter amount was invested to provide an after-tax yield of 5.5 percent for 10 years, the employee would have $55,000 available on retirement in year 10, as in the example above. The after-tax cost of the arrangement to the employer in year 1 would be approximately $32,780, or $1,600 better than the RCA alternative.

The difficulty in this arrangement is that the employer has no assurance that the employee will meet the conditions agreed upon to earn the retiring allowance. The employee will not receive any deduction if the amount is required to be repaid to the employer; however, in economic terms, the employee will be in the same situation, provided that the funds held in the investment account are used to pay the tax arising on the income. Security to the employer might be structured in advance, in the form of an agreement

[46] This is normally the model that insurance-funded RCAs are evaluated against. However, as will be seen from the discussion that follows, other investment alternatives can be structured which could provide worthwhile after-tax yields until the funds are required for distribution.

for payment of damages by the employee in the event that he does not fulfil his commitment.

Contribution Followed by Share Subscription

As can be seen from the previous two examples, one party always has a potential advantage over the other. The facts of each situation will dictate the appropriate balance between leaving the employee exposed and leaving the employer exposed. In the following example, the employee is given security in the form of shares of the employer.

The employer establishes an RCA in favour of a particular employee. An initial contribution of $100,000 is made to the RCA trust, $50,000 is remitted to Revenue Canada, and the remaining $50,000 is used by the custodian of the RCA to subscribe for common shares of the employer. The employer's net cost of the arrangement would be as follows:

Initial contribution	$100,000
Tax savings @ 44%	(44,000)
Proceeds from common share subscription	(50,000)
Net cost	$ 6,000

At the end of 10 years, assuming no change in the value of the shares, the employer would simply redeem the common shares held by the RCA trust for their $50,000 fair market value, and the RCA trust would then pay to the employee the $100,000 retiring allowance, which would be funded by the $50,000 from the share redemption and the $50,000 RCA tax refund. The cost to the employer of meeting the retiring allowance commitment in this manner would be the initial $6,000 plus the present value of the $50,000 share redemption 10 years hence (approximately $19,000, assuming a 10 percent after-tax discount rate to the employer), for a total cost of approximately $25,000 for the employer.

It is interesting to see what happens when the employer pre-funds the $100,000 commitment with a $200,000 contribution to the RCA trust, of which amount $100,000 is forwarded to Revenue Canada and the remaining $100,000 is used to subscribe for $100,000 worth of common shares of the employer. The employer's initial out-of-pocket cost is $12,000, as follows:

Initial contribution	$ 200,000
Tax savings @ 44%	(88,000)
Proceeds from common share subscription	(100,000)
Net cost	$ 12,000

In this situation, the employee's full retiring allowance becomes secured by the $100,000 deposit with Revenue Canada. If the employer were to fall into financial difficulty toward the end of the 10 years and the common shares became worthless, the custodian would be able to fund the retiring allowance by obtaining a refund of the refundable tax. The custodian would do this by ensuring that at the end of the year, all of the subject property of the arrangement, if any (and excluding a right to claim a refundable tax), consisted only of cash, debt obligations, shares listed on a prescribed stock exchange, or a combination of these. The custodian could then elect to treat the fair market value of all such property as the refundable tax at the end of the year.[47] As a result, any balance of refundable tax could be recovered and used to pay a distribution.

In this case, if the common shares were not listed on a prescribed stock exchange, they could be disposed of by the RCA trust for fair market value, so that a capital loss would be realized. Making the election would result in a $100,000 refund of tax, which could then be distributed (net of the appropriate withholding tax) to the retiree. For what it is worth, the cost to the now-defunct employer of meeting the $100,000 commitment would simply be the $12,000 prepayment of tax 10 years ago.[48]

Loan to an RCA Trust

Assuming that the trustees would allow a loan to be incurred, and that a loan to the RCA trust would not constitute a contribution, the loan could be used as an effective mechanism, along with a share subscription, to fund the plan. Consider the situation in which $100,000 of shares in the employer are to be acquired with the proceeds of the employer's contribution to the RCA trust. Dividends on the shares yield 7.5 percent. The employer establishes an RCA trust, and makes a $100,000 contribution and a $50,000 loan with interest at 15 percent. After remitting $50,000 to Revenue Canada, the RCA trust acquires $100,000 of the employer's shares. The $100,000 of shares yields $7,500 of dividends, which will be subject to the 50 percent part XI.3 tax. However, the $7,500 of interest paid to the employer to acquire the shares will be deductible; consequently, the RCA trust will have no income. If the employer as the maker of the loan is not currently taxable, the employer is in the same cash flow position (on a consolidated basis) vis-à-vis the interest on the loan and dividends on the shares. The RCA trust is thus able to accumulate the growth in value of the shares on a tax-deferred basis, since capital gains are subject to tax only on the disposition. Once the RCA trust has accumulated a value sufficient to meet the obligation, the shares can be disposed of and the loan from the employer repaid, with any excess funds being returned to the employer. Care would have to be taken in structuring the arrangement to ensure that the reversionary trust rules in subsection 75(2) would not be applicable to attribute any gain back to the employer. It is interesting to note that the exceptions to the reversionary trust rules in subsection 75(3) do not include a reference to an RCA but do include a reference to an EBP.

To illustrate the effect where the value of the shares increases, assume that the $100,000 of shares acquired by the RCA trust doubles in value in

[47] Subsection 207.5(2).

[48] Since there is an indefinite carryforward of losses (non-capital or otherwise), the funds arising on the refund of RCA tax in this example could be left in the RCA trust and invested to earn income that could be sheltered by the capital loss available to the RCA trust.

the first five years of the plan. The RCA trust could dispose of the shares, realizing a $100,000 gain that would give rise to $50,000 of refundable RCA tax. The RCA trust would then have $150,000 cash and $100,000 in refundable RCA tax. The original $50,000 loan could be repaid to the employer, and the remaining $100,000 cash could be distributed to the employer in satisfaction of part of the employer's interest in the trust. This would give rise to a $50,000 refund of RCA tax, which could then be invested by the RCA trust; the remaining $50,000 in refundable tax would be available for refund when the retiring allowance was paid. The employer would have to include the $100,000 distribution in income under paragraph 12(1)(n.3), to the extent of amounts previously deducted by the employer under paragraph 20(1)(r), being $100,000.

If a more significant gain were to accrue on the shares held by the RCA trust—for example, the shares tripled in value—the result would be as follows. The RCA trust would dispose of the shares for $300,000, realizing a $200,000 gain that would give rise to $100,000 of refundable tax. The RCA trust would then have $200,000 of cash and $150,000 of refundable tax. Of the cash amount, $50,000 would be used to repay the original loan from the employer and $200,000 (being the surplus in the RCA) would be distributed to the employer. This would give rise to a $100,000 refund of RCA tax. The employer would be subject to tax on $100,000 of the distributed amount under paragraph 12(1)(n.3); the remaining $100,000 of the distribution would come into the employer's income by virtue of paragraph 56(1)(y) as proceeds of disposition of the employer's interest in the RCA. Since paragraph 107.2(d) deems the proceeds from the disposition of the interest to be the adjusted cost base of the interest immediately before that time, no gain or loss would arise on the interest in the RCA itself.

The following table summarizes a taxable employer's position under the above scenario, assuming a 100 percent and a 200 percent increase in value. The employee would still receive a $100,000 retiring allowance in year 10.

	Cash flow: in (out)	
	100 % increase in value	200% increase in value
Year 1:		
Initial contribution and loan	$(150,000)	$(150,000)
Share subscription proceeds	100,000	100,000
Tax savings at 44%	44,000	44,000
Years 1 through 5:		
Interest received on the loan	37,500	37,500
Tax on interest	(16,500)	(16,500)
Dividends paid on the shares	(37,500)	(37,500)
Year 5:		
Repayment of loan	50,000	50,000
Taxable RCA distribution to employer	100,000	200,000
Tax on distribution	(44,000)	(88,000)
Total inflow (outflow)	$ 83,500	$ 139,500

The above scenario assumes that the RCA trust would sell the shares in the open market. The effect on the corporation's capital structure would have to be evaluated, and the present value of cash flows would have to be calculated to provide a more accurate reflection of the ultimate cost to the employer. The principles embodied in the plan essentially provide the employer with a low-cost method of funding the arrangement while at the same time tapping the equity market to fund the retirement plan.

Use of a Holding Company

The custodian of an RCA could use a holding company to gain a partial deferral of tax on Canadian equity investments. This would reduce the refundable tax from 50 percent, where the equity investment is held by the RCA, to 25 percent in the corporation. The 25 percent tax in the corporation would be recovered since taxable dividends are paid to the RCA trust, and the trust would then be subject to a 50 percent refundable tax on that amount, which would be recovered as distributions were made to the beneficiaries.

CONCLUSION

The rules relating to RCAs are just over three years old. As in the case of the original EBP rules introduced in 1980, it will be a number of years before these rules will be fully understood and effectively utilized to achieve the goals of both the employer and the employee.[49] With a stronger demand by senior executives for funded supplemental retirement arrangements, tax planners can expect to see the RCA rules used with increasing frequency and, one hopes, with greater imagination. The rules at first glance appear to be somewhat harsh; however, once the components that give rise to the tax are analyzed and understood, it becomes apparent that the rules are in fact quite flexible.

BIBLIOGRAPHY INFORMATION
Michael O'Connor, "Funding Supplemental Retirement Plans," Personal Tax Planning feature (1991) 39:1 *Canadian Tax Journal* 149-166.

[49] See, for example, Joanne Magee's comments at the start of her 1984 article on EBPs, which appeared in this feature: "Employee Benefit Plans Revisited," Personal Tax Planning feature (July-August 1984), 32 *Canadian Tax Journal* 773-91. Notwithstanding the subsequent changes to the legislation, the commentary is still relevant to the few situations in which EBPs continue to exist.