

Retirement Compensation Arrangement – an Overview

– An Effective Use of Tax Legislation to Create
Creditor-Proof Assets for High-Income Earners

Adequate Tax-Assisted Savings

Successful small and medium business owners, professionals and executives earning over \$200,000 have to pay a lot of income tax and enjoy few risk-free tax deductions to help them maximize their wealth and create a retirement stream of income.

For a high-income earner, the tax-assisted savings of an RRSP, IPP or registered pension plan are totally inadequate for the accumulation of capital necessary to provide for the family's financial needs during retirement.

However, corporations can set-up one or more retirement compensation arrangements (or RCA) to fund retirement benefits that go far beyond RRSPs and registered pension plans. RCAs have been allowed under the Income Tax Act since 1986. Currently, there are about 2,400 RCAs.

How Does it Work?

Under an RCA, amounts are deposited in a trust and investment proceeds are payable at termination of employment (loss of office), retirement or death as a lifetime pension, in a lump sum or as a series of installments. Contributions to an RCA are 100% deductible to the company and not taxable to the employee until paid out.

Unlike RRSPs, DPSPs and defined contribution pension plans, an RCA has no limit on the amount of contributions and retirement benefits that can be paid to an employee, making them ideal for executive, business owners and high income earners. The only requirement is that contributions and benefits be reasonable in light of the employee's service and earnings.

Unlike Individual Pension Plans, which covers only the first \$100,000 of earnings, all earnings under an RCA can be recognized in the determination of benefits. Moreover, RCAs are not covered by provincial pension legislation, which means that there are no onerous compliance requirements and especially no locking-in of assets. The taxpayer can still contribute to his/her personal RRSP while participating in the RCA. Unlike IPPs, money is not in straightjacket and pension payments are not severely restricted.

The company enters into a trust agreement with the employee who acts as his own trustee and custodian of the funds and decides on the investments. At retirement, termination of employment or death, the company hands over the administration to the beneficiary of the trust.

Example

For example, a company would require an annual contribution of \$98,000 for a 40-year old employee earning \$200,000.

Assuming contributions continue until age 60, the RCA will have \$3,562,000 based on a pension of 2% of best average earnings for each year of service in the corporation, in line with Canada Revenue Agency's guidelines for reasonability.

The pension can be paid as an indexed lifetime pension of \$125,000 continuing to the surviving spouse, or the \$3,562,000 can be paid over a number of years. For example, there would be enough money to pay an annual pension of \$235,000 over a period of 20 years.

Why is it Appropriate Under the Right Circumstances?

The RCA is often appropriate where company ownership is closely held or has non-shareholder senior executives.

The RCA makes it possible to obtain significant corporate tax deductions, defer amounts for payment after retirement, reduce the current tax burden of profitable companies and is an interesting alternative to highly taxed bonus payments and dividends paid from retained earnings.

It is a way to create a post-retirement stream of income that will provide adequate income to the employee, his or her spouse, children or other beneficiary and in this way can be an effective inter-generational wealth transfer tool.

The RCA is also a risk-free wealth preservation tool. Assets are held in trust separate from the company and protected from creditors.

RCAs are not subject to provincial pension legislation. Thus, they have much less onerous compliance requirements and complete flexibility with respect to funding and distributions, and none of the restrictive rules that apply to registered pension plans, such as locking-in.

Why Are RCAs Not That Common?

Because registered pension plans provide inadequate coverage relative to executive compensation, the primary use of RCAs has traditionally been to provide comparable security for their pension promise, in particular for public companies. RCAs can be very expensive to set-up and maintain, but they can also be set up in a way that is streamlined and cost-effective.

RCAs require the specialized skills and professional qualifications of an actuary for the design and valuation of the arrangement. There are about 2,500 qualified actuaries in Canada, and only a few practice in this field and even fewer provide services to small and medium size businesses.

Because RCAs require the involvement of an actuary, accountants are often not familiar with them and rely on other strategies for tax minimization, such as paying out bonus or dividends to maintain the small business deduction exemption.

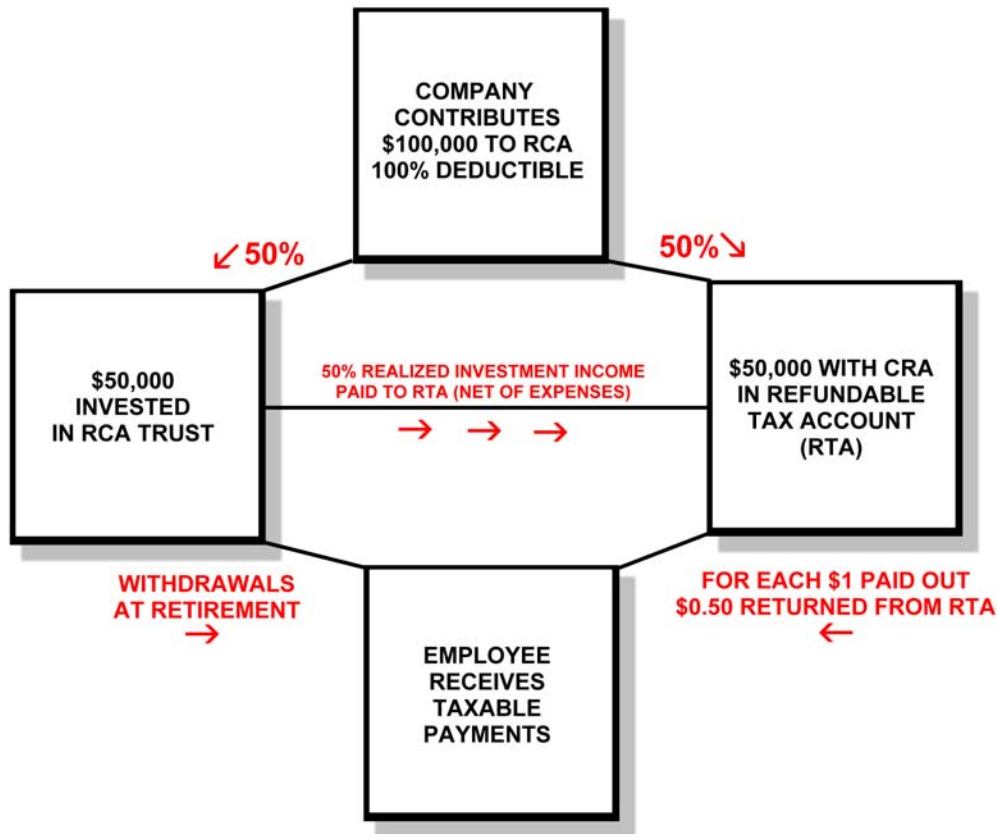
With more and more business owners inching toward retirement, business succession and financial security are now increasingly coming to the forefront. With reasonable set-up costs, a streamlined implementation, outsourced administration and self-trusted arrangements, the RCA is becoming a cost-effective strategy that deserves serious consideration.

What Are the Next Steps?

Complete our data sheet and send it to us in confidence and we will provide a free personalized analysis that will help you assess if an RCA is a strategy that will help maximize your wealth.

If you require further information, please call us or have your trusted advisors or accountants contact us for a personal discussion.

Retirement Compensation Arrangement



Contributions to RCA Trust and Refundable Tax Account

- RCA contributions are deposited in a trust, i.e., assets are separate from the company and protected from creditors
- Contributions to an RCA are 100% deductible to the company and not taxable to the employee until paid out
- 50% of contributions go to the RCA trust account
- 50% of contributions go to the Canada Revenue Agency in a Refundable Tax Account (RTA) – Amounts in the RTA earn 0%
- Each year, 50% of taxable investment income LESS expenses and distributions is remitted to or refunded from the RTA
- For each dollar paid out as a distribution from the RCA, \$0.50 is paid back from RTA account until balance in RTA is \$0
- At retirement, termination of employment or death, the company may hand over administration to the beneficiary of the trust

RCA Distributions

- Distributions are payable at termination of employment (loss of office), retirement or death and are paid as a lifetime pension, in a lump sum or as a series of installments over a number of years
- There are no limits on contributions and retirement benefits, the only requirement is that contributions and benefits be reasonable based on employee's service and earnings
- On death, funds may be paid to spouse as a lump sum or survivor pension or paid to a beneficiary

Funding

- There are no funding requirements - complete contribution flexibility
- Pension promise can be increased or decreased
- Tax-exempt life insurance provides full deferral of investment income in RCA trust

Benefits

- Lower tax payable during retirement
 - Tax reductions may continue in the future to match other industrialized countries
 - Currently, top marginal tax rate is 29% for income exceeding about \$115,000
 - By law, tax brackets are indexed annually in line with inflation
 - If inflation remains at about 2.5%, the income threshold for the top marginal tax rate will be \$190,000 in 20 years
- Can defer starting distributions to maximize tax savings, for example in the year after taking a large gain such as a company sale, or after depleting taxable non-registered assets or RRSP
- If beneficiary becomes a non-resident, withholding tax is generally 15% on installments and 25% on lump sums; in some cases lower withholding applies depending on tax treaty
- Taxpayer can still contribute to a personal RRSP
- No heavy compliance, locking-in or restricted payouts as with an Individual Pension Plan
- No need to purchase an annuity or have a corporation after distributions begin
- Beneficiaries of the RCA Trust can be custodian (i.e. self-trusted arrangement)
- Complete flexibility with respect to investments
- Essentially RCA contributions are fully tax-deductible, realized investment income is fully taxable