tax efficient
retirement
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business
GUIDELINES

Retirement Compensation Arrangement

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Supplement Retirement Income while providing Tax Deductible contributions

A guide to one of the most tax-efficient retirement planning tools you can give yourself or provide to your key employees!

RRSPs and Pension Plans provide an excellent source of income in retirement and are an absolute necessity for every Canadian planning for retirement. However, there are limitations. General guidelines suggest that we should retire on roughly 70% of our pre-retirement income. For many high-income earners and business owners, the current restrictions on RRSP contributions limit the amount they can invest in a tax-deferred program and the current Pension ceiling limits the amount they can draw from a Defined Benefit Pension Plan in retirement. Basically, the more money you earn, the harder it is to save for retirement on the full 70% of your pre-retirement income.

RRSP Limits:	18% of income to a maximum of $14,500 (increasing to $18,000 by 2006 and is indexed thereafter).
Defined Benefit Pension Plan:	Currently capped at $1,722 for each year of service to a maximum of $60,278 and increasing to $2,000 by 2005 with a maximum of $70,000 (equivalent to 35 years of service).

Anyone earning over $100,000 cannot utilize the full 18% of income limitation on RRSP contributions, and Defined Benefit Pension Plans are currently maxxed out at $70,000.

It is because of this inability for high-income earners and business owners to adequately save in a tax sheltered environment, that the Retirement Compensation Arrangement (RCA) has gained such recognition over the last several years.

What is a Retirement Compensation Arrangement?

To quote Canada Customs and Revenue Agency (CCRA) on their definition of the Retirement Compensation Arrangement (RCA):

> " A Retirement Compensation Arrangement (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 of eventually distributing them to the employee (beneficiary) on, after, or in view of retirement, the loss of an office or employment, or any substantial change in the services the employee provides (e.g., an athlete being retained as a scout after the end of a professional playing career)."

An RCA allows an employer to make tax-deductible contributions to the custodian of a trust, to fund benefits that an employee will eventually receive when there is a substantial change in the employee's employment situation (such as retirement). The custodian then invests these contributions into any number of possible investments.

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Structure:

Employer/Participant
100% Tax Deductible Contributions

$100,000
Tax Deductible to Employer

$100,000
Tax Deductible to Employer

RCA Investment

A $200,000 contribution by the employer sees $100,000 go to the RCA and $100,000 to the RTA

RTA Refundable Tax Account

Money is withdrawn to pay the benefits to the employee

As money is withdrawn from the investment, money from the RTA is refunded to the RCA Trust. The ratio is $1 from the RTA for every $2 received in taxable income.

RCA Trust

Employee – Taxable Benefits

Taxation of an RCA

1. The RCA is designed to enable employers to make reasonable tax-deductible contributions on behalf of specific business owners or employees who are enrolled as participants in the plan. As these contributions must be reasonable, it is strongly suggested that an Actuarial certificate be included with every RCA, certifying that the benefits provided for in the agreement are not excessive. From every contribution:

    a. 50% is remitted directly to the Canada Customs and Revenue Agency (CCRA) as the Refundable Tax Account (RTA)

    b. 50% is invested by the custodian

    NOTE: CCRA also permits tax-deductible contributions by the employee, provided that the contributions do not exceed those of the employer and there is an employment agreement in place outlining the required participation of the employee.

2. As the money is invested by the custodian, the investment will earn a combination of interest income, dividend income and realized gains. This income, regardless of type of income, is also subject to the 50% tax and half the interest earned must be remitted to the CCRA. There is no preferred tax treatment given to capital gains or dividend gains. Precisely why the Universal Life product is one of the most often used investments inside an RCA Trust.

Universal Life Advantage

Interest earned in a Universal Life policy is tax-deferred. As a result, 100% of the income stays within the RCA and the custodian is not required to remit any of this income to the CCRA. However, interest earned in the side account is not tax-deferred, and 50% of this interest must be remitted to the CCRA. It is for this reason that using a Universal Life policy inside an RCA is viewed as one of the more tax-efficient investments.

3. As payments are made from the RCA Trust, to the employee, the income is treated just as pension income and is subject to tax in the normal manner. However, should the recipient no longer be a Canadian taxpayer because of emigration from Canada, lower tax rates may apply depending on the applicable tax treaty.

4. Again, when payments are made from the RCA Trust to an employee, money is refunded from the Refundable Tax Account to the Trust at the rate of $1 for every $2 received by the employee.

Funding an RCA using Life Insurance

There is any number of investments that can be held within an RCA including property, stocks, bonds etc. Each year 50% of all interest income, dividend income and realized capital gains earned in the RCA must be remitted to the CCRA to comprise part of the Refundable Tax Account. This is why a tax-deferred Universal Life policy is such an attractive investment. The interest earned each year is not taxable until funds are removed from the plan. Therefore, no remittance to the CCRA on the interest component is required.

When using insurance, the RCA Trust purchases a Universal Life policy on the life of the employee and over funds the policy. The over funding component builds the Cash Value of the plan. It is the Cash Value that will be used to provide the benefits to the employee at retirement.

NOTE: When using a Universal Life insurance policy as the investment vehicle within an RCA it is imperative that the RCA be in existence prior to purchasing the UL.

Income through withdrawals

At the time of the employee's retirement, benefits are payable from the RCA Trust. When withdrawals are made from the Universal Life policy a taxable disposition takes place. The portion of the withdrawal that is taxable is considered income in the hands of the RCA Trust and is subject to the 50% refundable tax.

Consider a simple case. An owner/manager who wants to retire in 10 years time. By using the following information we can estimate a realistic pension amount and the pension gap that will exist.

Current Salary	$300,000	Current RRSP/RPP Balance	$550,000
Projected salary increase	2% / Year	Growth Rate	6%
Average Salary (last 5 years)	$344,741	Realistic Pension (70%) of average	**$241,319**

Assuming annual deposits of $14,500 for the next 10 years, along with a projected interest rate and current RRSP/RPP balance, we can determine how much our client can expect to receive through these traditional means. In this case $103,552. This leaves a gap of $137,767 ($241,319 less $103,552) and this is the amount that could realistically be funded through the RCA Trust.

How does it work? – A look at the numbers

Our client deposits approximately $100,000 annually for 10 years. The refund from the RTA occurs the year after the withdrawal is made. In year 11 the RTA refund is $0 and the entire benefit is withdrawn from the UL policy. In year 12 we have a refund of $44,935 and a withdrawal of $92,832. Which generates our $137,767 benefit.

Year	Withdrawal	Taxable Gain	RTA Refund	Total Income
11	$137,767	$47,897	$0	$137,767
12	$92,832	$37,117	$44,935	$137,767
13	$109,910	$49,301	$27,857	$137,767

The RTA refund in year 12 is calculated as:

$$\frac{\text{Withdrawal Year 11} \quad \text{minus} \quad \text{Taxable Gain Year 11}}{2}$$

So you can see that it is not always a $1 refund for every $2 of withdrawal from the UL plan. You may have to withdraw more than half the desired amount.

Leveraged RCA

The leveraged RCA plan offers the opportunity for a corporation to make tax-deductible contributions to an RCA while borrowing back a significant portion of the contribution.

Consider the following example of a company with $1,000,000 of taxable income:

Typically this company would have two options available to them.

1. Bonus out the $1,000,000 to shareholders who will pay personal tax on the income and then arrange to borrow back the after tax value through a shareholder loan.
2. Pay tax within the corporation and reinvest the after tax value.

With both these options there will be a significant, permanent loss to taxes.

Now consider the Leveraged RCA plan:

	Corporation	RCA Trust
RCA Contribution	($1,000,000)	$1,000,000
RCA Trust Assets RTA Investment		 $500,000 $500,000*
Working Capital Loan	$900,000	

Results:
- Corporation has a fully tax deductible contribution
- Temporary tax loss of $500,000 is fully refundable and can be used as collateral for the loan
- Up to 90% of the value of the RTA plus the Investment can be leveraged back

* This value will be less when investing in an insurance policy as there will be premium tax and cost of insurance deducted. Also with large single premium cases there will be a taxable side account used. **Always seek professional tax and/or legal advice.**

Here's how it works:

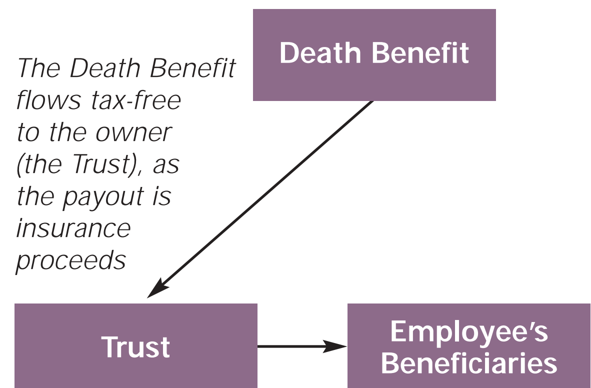
1. The corporation makes a tax-deductible contribution to the RCA Trust to fund the eventual retirement benefits of an employee.
2. The Trust remits 50% of the contributions directly to the CCRA and purchases a Universal Life insurance policy with the other 50%.
3. The Trust arranges, with a financial institution, to secure a loan using the total value of the RTA and the Cash Value of the policy as collateral.
4. The financial institution lends the Trust up to 90% of the total value of the RTA and the Cash Value of the policy.
5. The RCA Trust lends the money to the corporation.

NOTES: There will be significant expenses incurred in setting up a leveraged RCA so this option should not be considered unless the contribution is significant. Generally the lending agreement will require that the loan be paid off prior to paying out retirement benefits from the Trust.

Death Benefit

Another benefit of using a Universal Life insurance policy as the funding mechanism within an RCA is that the insurance coverage provides Estate Protection through the Death Benefit. Usually, there is a provision for the beneficiaries of the employee to receive the assets held in the RCA when the employee dies prior to distributing all the assets as retirement income. The death benefit of the policy is paid tax-free to the RCA, the owner of the insurance policy. However, these proceeds are taxable when they find their way to the employee's beneficiaries as they are no longer considered proceeds from an insurance policy but merely a distribution of assets from an RCA.

On death of employee:



When the undistributed funds in the Trust (including the Death Benefit) are distributed to the beneficiaries they are 100% taxable as they have lost their insurance proceeds standing.

To combat this taxable event of a Death Benefit payout, **Split Dollar RCAs** have become more and more common as they offer more flexibility.

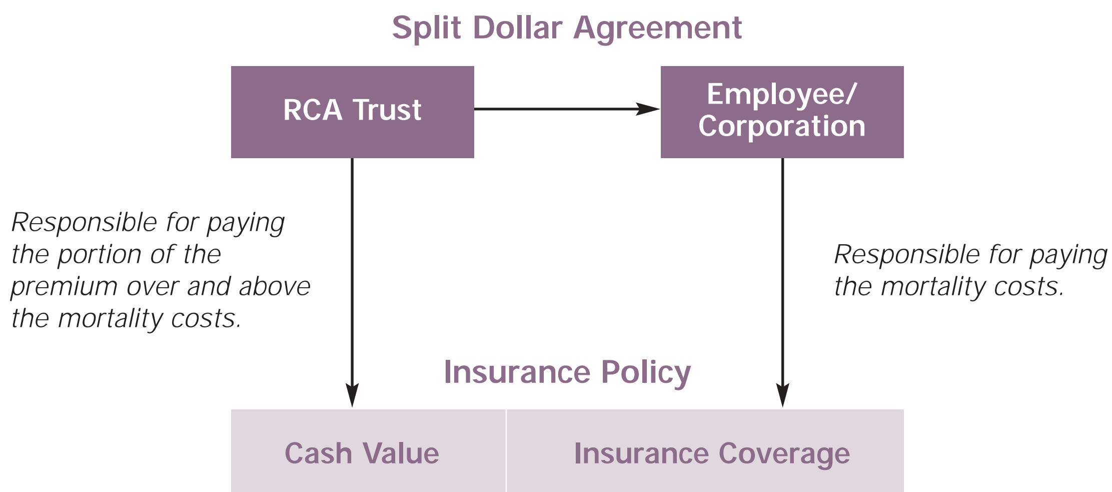
Split Dollar RCA's

In a split dollar RCA structure the ownership of the Universal Life policy is usually split between the RCA Trust and the employee/ corporation. The employee/corporation normally owns the face amount and the RCA owns the cash value. The parties involved enter into an agreement and each is responsible for paying a portion of the premium. Typically, the employee/corporation owns the face amount and is responsible for paying the mortality charges of the coverage. In this type of arrangement the insurance component is held outside the RCA. The RCA Trust owns the cash value of the plan and is responsible for paying the over funding component. This cash value is used as the funding mechanism for the retirement benefits payable to the employee/corporation.

There are 2 distinct advantages to this type of arrangement. First, the employee/corporation owns the face amount and this is held outside the RCA. Therefore, on the death of the insured the death benefit does not flow through the RCA but flows directly to the beneficiary of the contract. This removes the tax implication that occurs when the Death Benefit flows first to the RCA and then to the employee/corporation's beneficiaries.

The second clear benefit is that, because the insurance component is funded by the employee/corporation instead of the RCA, and is typically held outside the RCA, there is no RTA remittance required on the portion of the deposit required to pay the mortality charges.

These types of Split Dollar arrangements require great care when paying deposits to ensure that neither side is perceived as having received a benefit from the other. In other words, if the employee/corporation does not pay enough then the CCRA could view it as the employee/corporation having received a benefit from the RCA and will be taxed accordingly. Or, if the employee/corporation pays too much in relation to the RCA, then the CCRA could view it as the RCA having received a benefit. This could result in remittance to the RTA of an amount equal to the perceived benefit received by the RCA. The easy solution is to be very careful when determining how much each party will contribute to the deposit.



Who should consider participating in an RCA?

An RCA should be considered for employees or business owners who:

- Have a significant income
- Are looking to replace the bonus down strategy
- May be a non-resident of Canada upon retirement (e.g. professional athlete)
- Are looking for creditor protection on corporate assets
- Wish to reward key employees over and above traditional retirement planning methods
- Are experiencing strong growth and are looking to replace the shareholder loan with a leveraged RCA

How do I set up an RCA?

To establish an RCA the following steps are required:

1. The employer sets up a Trust. They can select three individuals, one of whom must not be a Director or Officer, nor be related to a Director or Officer, nor be an employee, to act as Trustees of the Plan. Or, the Trustee of the Plan could be a trust company or other financial institution.
2. The employer then establishes an RCA Trust Indenture (explained briefly below).
3. The employer then establishes an RCA Plan Text (explained briefly below).
4. A Director's Resolution establishing the plan must be passed.
5. The Trustees then enter into arrangements with various Financial Institutions in order to invest the assets of the plan.
6. The Trustees establish a bank account for the RCA.
7. The employer then arranges for both the Trust Indenture and the Plan Text to be registered with the CCRA.

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What is a Trust Indenture?

A Trust Indenture is quite simply a Trust Agreement between the Company establishing the Retirement Compensation Arrangement on behalf of their employees and the parties appointed as Trustee/s of the RCA. It sets out such guidelines as:

- Payments from the Trust
- Investment of Trust Fund
- Powers of Trustees
- Accounts and Records
- Responsibilities and Limitations
- Trustees Compensation
- Resignation, Removal, Replacement of Trustees

The Trust Agreement must be signed by a representative of the company who has authority to bind the company, and by each of the trustees identified in the Trust Agreement. Each signature must have a corresponding Witness.

What is the Retirement Compensation Arrangement (RCA) Plan Text?

The RCA Plan Text is the actual plan set up for the participant of the RCA and the Employee of Plan. Typically outlined in these plans are:

- Construction of the plan
- Eligibility and Enrolment
- Contributions
- Benefit Options on Termination of Employment
- Plan Benefits
- Benefits on Death
- Funding and Administration of the Plan

For further information please refer to the CCRA's
"*Retirement Compensation Arrangements Guide*".
This is a publication outlining the roles and responsibilities
of the Employer and the Custodian of the Trust.

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