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Retirement Compensation Arrangements and Lower Taxes - Why Albertans Buy RCAs

By Roy W. Craik

When a Retirement Compensation Arrangement (RCA) is established for key employees, no concern is given to the employee's personal tax rate since the supplemental pension provided by the RCA is considered part of the benefit package and is not taxable in the employee's hands until retirement.

An RCA for an owner/manager or controlling shareholder is sometimes viewed differently by accountants and investment advisors, in that, this individual could take the same funds by way of a bonus and pay personal taxes at a rate lower than the 50% remitted to the RCA Refundable Tax Account (RTA). This means that more money is available for investment and conventional wisdom says this should result in more long-term income.

Salary Deferral Arrangement Rules

It is important to first understand the Salary Deferral Arrangement (SDA) rules. If the funds in question can be taken as either a bonus or a contribution to an RCA, the RCA will likely be deemed an SDA. Bonus income should continue to be paid as it was prior to setting up the RCA. Funds that go to an RCA must be clearly defined as part of the benefit plans or arrangements offered by the company. A total bonus cannot be dropped into a RCA without SDA concerns. Alternatively, once an RCA has been established it is important for the company to continue the planned pattern of contributions or, again, risk the possibility of having the RCA deemed an SDA.

Purpose of The RCA

The RCA is intended to provide a supplemental pension under the "Generally Accepted Guidelines". Because retirement is usually many years away the RCA can:

• Defer personal tax to retirement at then, potentially lower, personal rates

• Tax shelter investment earnings providing tax-exempt life insurance, such as R^C^F's through PENSION*Plus*™, if used as the funding vehicle

• Potentially provide creditor protection for assets

Investment Loss Protection

Few owner/managers today would keep their entire personal investment portfolio in equities. Some part of their portfolio is likely in more conservative fixed income instruments such as GICs or bonds. This, conservative portion of the whole portfolio, is the part that would normally be allocated to the RCA. A failure to acknowledge this, on the part of the financial advisor, can result in unrealistic comparisons being used to justify the "bonus-out" scenario, which may not be in a client's best interests over the long-term.

Funds allocated to RCAs are for long term supplemental pension needs where protection is a key requirement. If these same funds are "bonused-out", the owner/manager has paid the personal tax and could take losses on the after tax money as a result of poor performance of the investments selected.

Although, the same investment losses could occur in the RCA, the money in the Refundable Tax Account is not at risk for investment losses because it is not invested.

In addition, in the "bonus-out" scenario, investment losses can only be used against investment gains. In the RCA, the RTA money becomes available regardless of the performance of the RCA Investment Account.

How many clients who were talked into the "bonus-out" strategy for additional retirement income now wish that they had used the RCA? No matter how bad the stock market drop, 50% of their money would have been insulated from this risk.

The Mathematics

RCAs were designed to be essentially tax neutral. When the legislation was enacted in 1986, personal rates were approximately 50%. On a non tax-sheltered basis, both the RCA and the “bonusout” strategy would have provided the equivalent extra pension. The RCA was primarily used to provide supplemental benefits for employees of public corporations and for owner/ managers as a means to separate these assets from their businesses in order to, hopefully, provide creditor protection.

As personal tax rates decline some would think that the advantage would go to the “bonus-out” strategy. For conventional RCAs, this thinking is correct to a certain extent, but not so using a tax-exempt life insurance policy as the funding vehicle in the RCA.

Conventional RCA

In a conventional RCA, 1/2 of all gains in the RCA Investment Account must be transferred to the Refundable Tax Account (RTA) that earns no interest. This also applies to capital gains and dividends.

Looking again at a client's total investment portfolio, it is evident that it makes no sense to hold equities in a conventional RCA for the owner/ manager of a private corporation. The 50% inclusion rate for capital gains outside the RCA means that tax paid outside the RCA is much lower than the 50% that must be remitted to the RTA in the conventional RCA. Similarly the preferential tax treatment of dividend income means that it is more attractive to receive that income outside of the RCA. Looking at the RCA as part of a balanced portfolio, in a conventional RCA, the RCA Investment Account should hold primarily fixed income assets.

Personal tax rates would have to drop dramatically by retirement for the conventional RCA invested in equities to outperform the “bonus-out” strategy.

Life Insurance Funded RCA

When we examine an RCA, the important consideration is the spread between the 50% contribution to the RTA and the owner/manager’s personal tax rate. The most extreme example is provided by the province of Alberta, where the highest personal tax rates currently are approximately 39%. This means that for every $100 of gross income only $50 would be invested in the RCA Investment Account versus $61 if “bonused out”.

However, it must not be forgotten that it is only the opportunity cost that must be considered.

The difference between what goes to the RTA and the after tax bonus is not lost money. The real cost is only the earnings on this difference. So let’s look at the earnings on the $11 dollar difference. At 5.5%, this represents approximately 37 cents. Even in Alberta, with the lowest tax rates in Canada, the lost opportunity is only approximately **1/3rd of 1 cent annually for each gross $1.00 invested in an RCA.**

Summary

A Retirement Compensation Arrangement allows an owner/manager, to diversify and potentially provide creditor protection for some assets. Only a portion of a private corporation’s total potential bonus pool can be allocated as RCA contributions under the “Generally Accepted Guideline” calculations. This portion along with regular RRSP, MPPP or IPP contributions assures an owner/manager that, if made on an orderly basis and assuming conservative investment assumptions, he or she will at least have an adequate pension.

Assuming current tax rates and a buy-hold strategy, “bonusing-out” can be illustrated to outperform a non-tax sheltered RCA. However, realistically, the “bonus-out” strategy will not outperform or offer the extra advantages of the tax sheltered RCA. The wealthy owner/ manager has room for both. The RCA provides the security of knowing that he or she has put away funds to provide an adequate total pension. The “bonus-out” of funds over the allowable RCA contribution provides “play money” for the extra lifestyle that most owner/ managers strive to achieve, either now or in retirement.

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RCF is the creator of the RRSP***Wrap***™, IPP***Wrap***™, MPPP***Wrap***™, and PENSION***Plus***™. RCA trust services are provided by BMO Trust Company.

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