Tax memo

Canadian tax updates

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Employee benefits and executive compensation: Draft legislative proposals released

Discusses August 14, 2012 draft legislative proposals in respect of employee benefits and executive compensation.

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On August 14, 2012, the Department of Finance (Finance) released draft legislative proposals that implement tax measures announced in the March 29, 2012 federal budget. Explanatory notes were also released.

This *Tax memo* discusses the draft legislative proposals in respect of employee benefits and executive compensation. Specifically, it considers proposals that affect:

- group sickness and accident insurance plans;
- retirement compensation arrangements;
- employee profit sharing plans; and
- registered disability savings plans.

Group sickness and accident insurance plans

Before the budget, employer contributions to a group sickness and accident insurance plan did not have to be included in the income of an employee, and only periodic benefits paid under a "wage loss replacement plan" funded with employer contributions were taxable in the hands of an employee at the time of receipt. Other benefits paid under a group sickness and accident insurance plan, including lump sum benefits, generally were non-taxable benefits to an employee.

The changes

The draft proposals require the amount of an employer's contributions to a group sickness and accident insurance plan to be included in the income of the employee in the year in which contributions are made. However, as is currently the case, there will still be no income inclusion to the extent that the contributions are in respect of a wage loss replacement plan that provides periodic benefits

The explanatory notes indicate, for example, that this provision is intended to apply in respect of employer-funded premiums for critical illness or dismemberment insurance, which generally pay lump-sum benefits. Notwithstanding that the draft proposals will treat employer contributions to group sickness and accident insurance plans as taxable benefits, the benefits paid to employees under these plans will continue to be treated as non-taxable receipts.

As well, this proposal will not affect the tax-free status of premiums and benefits under private health services plans, such medical and dental plans.

This provision will apply to all employer contributions made after March 28, 2012. However a transitional rule will defer, until the 2013 taxation year, the income inclusion for employer contributions made between March 28, 2012, and before 2013, in respect of coverage for 2012.

Retirement compensation arrangements

In very general terms, a retirement compensation arrangement (RCA) is defined by the *Income Tax Act* (the Act) as an employer-sponsored pension or retirement savings arrangement, other than a registered pension plan, registered retirement savings plan (RRSP), deferred profit sharing plan, employee profit sharing plan, group sickness and accident insurance plan or an employee trust, among other specific exclusions.

Generally, employers and employees are entitled to a deduction from income in respect of contributions they make to an RCA. Plan members are not taxed on employer contributions made to the RCA. Instead, an RCA is liable to tax at the rate of 50% on the contributions it receives and on the net income and net capital gains it earns (referred to as the "refundable tax account").

Plan members must include distributions from an RCA (typically as retirement benefits) in income at the time of receipt. In turn, distributions the RCA pays to its plan members will also generate a refund of tax to the RCA, from its refundable tax account, equal to 50% of the amount of the distributions made in the year.

A specific provision permits an RCA to file an election to trigger a refund of tax to the RCA when the value of its property has declined such that it is insufficient to fund the distributions made by the RCA to plan members necessary to generate a refund of tax paid by the RCA.

The changes

The budget announced that measures would be introduced to curtail certain problematic arrangements involving the use of RCAs. These include the triggering of employer deductions for large contributions that are indirectly returned to the employer through a series of loans and/or corporate asset strips that leave an RCA with insufficient assets to support distributions to plan members. In these circumstances, typically an election is filed by the RCA to trigger a refund of tax, on the basis that the asset value of the RCA has been impaired.

The draft proposals, generally effective after March 28, 2012 (with limited grandfathering), intend to restrict RCAs by:

- extending the "prohibited investment" and "advantage" rules that currently apply to RRSPs, registered retirement income funds (RRIFs) and tax-free savings accounts (TFSAs) to RCAs; and
- introducing restrictions on the ability of an RCA to file an election to obtain a refund of tax.

Tax on prohibited investments

The draft proposals levy a tax on the custodian of an RCA if:

- the RCA acquires a prohibited investment after March 28, 2012; or
- property of the RCA becomes a prohibited investment after March 29, 2012.

The tax is equal to 50% of the fair market value of the prohibited investment.

The draft proposals define a prohibited investment to have the same meaning as in the context of the TFSA, RRSP and RRIF rules, with a minor modification that replaces the reference to a "controlling individual" with a "specified beneficiary" of an RCA. A "specified beneficiary" is a person who:

- has an interest or a right in relation to an RCA; and
- has or had a "significant interest" in the employer in respect of the RCA.

As drafted, it appears that the phrase "had a significant interest in the employer" could apply, for example, to treat a plan member who acquires and divests of a significant interest over a brief period (e.g., upon the exercise of stock options immediately followed by a disposition of underlying shares) as a specified beneficiary and would continue to do so at all subsequent times.

Whether the definition of a specified beneficiary is intended to have such broad scope is not clear. The definition allows an RCA to have more than one specified beneficiary.

As proposed, a prohibited investment for an RCA generally includes a debt of a specified beneficiary or a share of, an interest in or a debt of, a person, trust or partnership in which the specified beneficiary has a significant interest, does not deal at arm's length or is affiliated with the specified beneficiary.

Of note, the draft proposals define the term significant interest to have the same meaning as provided by the TFSA rules. Finance released a comfort letter on June 13, 2012, that recommends narrowing the circumstances in which a holder of a TFSA (or annuitant of an RRSP or RRIF) will be considered to have a significant interest.

One recommendation in the comfort letter is to amend the definition of prohibited investment so that it generally will have the effect of preventing an investment from being a prohibited investment when an RRSP/RRIF annuitant (or a TFSA account holder) both lack a significant interest in the entity in question and deals at arm's length with the entity. The definition of prohibited investment in the draft proposals already reflects this comfort letter recommendation.

Similar to the existing rules in the TFSA context, the draft proposals provide for a refund of the tax that is imposed on a prohibited investment, if the custodian of the RCA disposes of the prohibited investment before the end of the calendar year following the calendar year in which the tax arose, provided that the prohibited investment was not knowingly acquired by the custodian or specified beneficiary as a prohibited investment. The Minister of National Revenue (the Minister) is also provided with discretion to refund the tax later if the Minister considers it reasonable in the circumstances.

A special rule provides that if a property held by an RCA trust ceases to be, or becomes, a prohibited investment of an RCA trust, the trust is deemed to have:

- disposed of the property for proceeds equal to the fair market value of the property at that time; and
- acquired the property at that time at a cost equal to that fair market value.

This rule is designed to assist in determining the advantage tax in relation to income and gains on prohibited investments. The triggering of income and gains on prohibited investments could also affect the RCA's refundable tax account.

Grandfathering for prohibited investments

The prohibited investment rules in respect of RCAs generally apply after March 28, 2012, with limited grandfathering,

The explanatory notes clarify that if a significant interest in a corporation, such as a debt of the corporation controlled by a specified beneficiary of an RCA, is already held by the RCA before March 29, 2012, it will not be subject to the 50% tax.

In addition, an amendment to the terms of a promissory note, or similar debt obligation, that is property of the RCA acquired before March 29, 2012, to provide for commercially reasonable payments of principal and interest is deemed not to be a disposition or acquisition of that note or obligation.

Tax on advantages

The draft proposals also levy a tax on the custodian of an RCA if an advantage in relation to the RCA is extended to or is received or receivable by an RCA, a specified beneficiary or any person not dealing at arm's length with the specified beneficiary. The tax is generally equal to the fair market value of the advantage.

The draft proposals define an advantage to closely follow the meaning given to this term in the context of the TFSA, RRSP and RRIF rules, with minor modifications to reflect certain attributes of an RCA. The proposed definition of advantage includes:

a) Any benefit, loan or indebtedness that is conditional on the existence of the arrangement, unless the loan or indebtedness has "arm's length" terms and conditions.

b) An increase in the fair market value of the property under the arrangement if the increase is attributable to a transaction or event (or series) when one of the main purposes was to enable a person or partnership to realize certain tax benefits, if this transaction would not have occurred in a normal commercial or investment context between parties dealing at arm's length, or includes a payment that was in satisfaction of certain amounts that would otherwise have been income to the specified beneficiary or a person not dealing at arm's length with the specified beneficiary.

c) Income and capital gains that are reasonably attributable to prohibited investments in respect of the RCA[1] or certain amounts received by a specified beneficiary or a person not dealing at arm's length with the specified beneficiary that would not otherwise have been income to the recipient.

d) The amount of any "RCA strip." The draft proposals define an RCA strip to closely follow the definition of an RRSP strip in subsection 207.01(1) of the Act. An RCA strip is intended to target transactions or a series of transactions that reduce the fair market value of property of an RCA when one of the main purposes is to enable a specified beneficiary or a person not dealing at arm's length with the specified beneficiary to use or obtain the benefit of the property or from any of the RCA rules, in respect of which there has been no income inclusion.

   The explanatory notes provide as an example of an RCA strip, a loan made by an RCA to a specified beneficiary, or a debt of a specified beneficiary acquired by an RCA, when steps are taken to ensure that the loan cannot be repaid. The explanatory notes also state that the RCA strip rules can apply to a debt acquired by an RCA before March 29, 2012, if the value of the debt is impaired after March 28, 2012 as part of a series of transactions that meets the test set out in the definition.

e) A prescribed benefit.[2]

Grandfathering for advantage rules

The advantages rules in respect of RCAs in the draft proposals apply after March 28, 2012, with limited grandfathering.

Transactions or events relating to property of an RCA acquired before March 29, 2012 will not give rise to an advantage if either:

- the amount that would otherwise be an advantage is included in the income of a beneficiary, or employer in respect of the RCA, for the taxation year in which the advantage arose or the following taxation year; or
- the property is a promissory note or similar debt obligation, commercially reasonable payments of principal and interest are made at least annually after 2012 and no RCA strip occurs after March 28, 2012.

In respect of this latter condition, amendments to the terms of a promissory note or debt obligation to provide for commercially reasonable payments of

1. It is therefore possible for the custodian of the RCA trust to be liable for a 50% tax on the acquisition of the prohibited investment as well as a 100% tax on any advantage arising from the prohibited investment.

2. The advantage rules in the RRSP, RRIF and TFSA context do not yet have any prescribed benefits. Presumably, this definition is intended to provide Finance the ability to expand the definition of advantage by regulation, as opposed to legislative amendments, should specific circumstances require it.

principal or interest will be deemed to not give rise to a disposition of the note or obligation.

Liability for taxes

One noteworthy difference between the existing prohibited investment and advantage rules that apply in the TFSA, RRSP and RRIF context and those in the draft proposals is that the latter create joint and several liability for the tax. A specified beneficiary of an RCA is jointly and severally liable for the tax that is levied on a custodian in respect of prohibited investments and advantages, to the extent that the specified beneficiary "participated in, assented to or acquiesced in the making of," the transaction, event or series of transactions or events that resulted in the liability. It is unclear why Finance considered this extension of liability to a specified beneficiary to be necessary.

The draft proposals give the Minister discretion to waive or cancel all or part of the taxes levied in respect of prohibited investments or advantages, when the Minister considers it just and equitable to do so, including when the tax arose as a consequence of a reasonable error or gave rise to tax under another provision of the Act.

The draft proposals also provide that when a custodian of an RCA, but not a specified beneficiary, has paid tax under the above provisions, the amount of tax paid (and not otherwise cancelled or waived) will be deemed to be a distribution made by the RCA to plan members for the purpose of computing the RCA's refundable tax. However, these "deemed distributions" will not be taxable to the beneficiaries of the RCA trust.

Restriction on the election for impaired assets

The draft proposals limit the ability of an RCA to claim a refund of tax by restricting the ability of an RCA to file an election in respect of asset value impairment. This restriction is imposed when the decline in asset value is reasonably attributable to a prohibited investment for, or an advantage in relation to the RCA, unless the Minister determines it is just and equitable to allow the election, having regard to all of the circumstances.

The restriction applies to elections filed in respect of contributions to RCAs made after March 28, 2012, and income and capital gains realized in respect of these contributions.

Employee profit sharing plans

The draft proposals implement measures announced in the budget to ensure that employee profit sharing plans (EPSPs) are being used for their intended purposes and to discourage excessive employer contributions for certain plan members.

New Part XI.4 imposes a special tax on a "specified employee" in respect of contributions to an EPSP that are an "excess EPSP amount." The term excess EPSP amount is defined to generally mean contributions that are in excess of 20% of the specified employee's income from office or employment, computed without reference to amounts allocated to the employee under an EPSP, stock options and certain deductions in respect of employment income.

The term specified employee is defined to generally mean an employee who owns, directly or indirectly, at least 10% of the shares of the employer corporation or an employee who does not deal at arm's length with the employer. The special tax imposed on an excess EPSP amount is generally equal to the top marginal combined federal and provincial/territorial rate applicable to the specified employee in his or her province or territory of residence (including provincial/territorial surtaxes but not taxes that are limited to a maximum amount).[3]

The draft proposals allow the Minister to waive or cancel all or part of the Part XI.4 tax when it may be just and equitable to do so. Information returns are also required to be filed in respect of a taxpayer's liability for taxes under new Part XI.4. Generally, a

3. If the specified employee is a resident of Quebec, the provincial rate is set at nil. Presumably, Quebec will enact similar provisions to impose its own rate of provincial tax. If the specified employee is not resident in a province or territory in the year an excess EPSP amount is determined (for example, a non-resident), the effective tax rate is set at 43%.

person liable for this tax must file a return on or before the person's tax return filing date for the year, estimate in the return the amount of tax payable by that person and remit the amount of tax payable under Part XI.4.

A taxpayer will be permitted to deduct from employment income an amount equal to the excess EPSP amount, in respect of which the taxpayer is liable for Part XI.4 tax (that was not otherwise waived or cancelled). This deduction ensures that the excess EPSP amount is not subject to double taxation.

These draft tax measures apply in respect of the 2012 and subsequent tax years, but do not apply in respect of contributions made to an EPSP before March 29, 2012, or pursuant to an obligation arising before this date.

Registered disability savings plans

The draft proposals implement the measures announced in the budget to improve the attractiveness of registered disability savings plans (RDSPs). One improvement allows the subscriber of a registered education savings plan (RESP) and a holder of an RDSP, in respect of the same beneficiary, to elect to transfer accumulated income payments from a RESP on a tax-deferred basis, to the RDSP. Several consequential amendments to the RESP and RDSP rules are proposed to accommodate this rollover.

Very generally, the draft proposals also introduce other rules to implement maximum and minimum withdrawal rules, terminate an RDSP following the cessation of eligibility for the disability tax credit, and facilitate certain administrative and filing requirements in respect of RDSPs.

For more help

If you have questions on the effect of the draft proposals on employee benefits and executive compensation, please contact your PwC adviser or the individuals listed below.

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