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Proposed changes to EPSPs and RCAs

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On August 14, 2012, the Department of Finance released draft legislation in respect of a number of Budget 2012 initiatives, including provisions addressing perceived abuses of employee profit sharing plans (EPSPs) and retirement compensation arrangements (RCAs). These changes could have a significant impact on privately held corporations where major shareholders or their family members are also employed by the firm.

Employee profit sharing plans

EPSPs have traditionally provided business owners with the flexibility to offer compensation programs that fluctuate directly with the profits of the corporation. After a period of consultation by the government, Budget 2012 announced targeted changes to the rules relating to EPSPs to prevent the perceived misuse of these vehicles in order to accomplish income splitting.

The proposed changes would apply to a "specified employee", generally being a person who owns 10% or more of a class of shares of the employer or a related company or is related to a person who owns such shares. The proposals provide that if amounts allocated by the EPSP to a specified employee exceed 20% of that individual's salary from the employer (including general benefits but excluding stock option benefits), then an "excess EPSP amount" will result and will be taxed at the highest marginal tax rate (including provincial taxes). The proposed tax will apply to contributions made to an EPSP after March 29, 2012 unless the payments are made before 2013 pursuant to a written obligation entered into before March 29, 2012.

If an individual is taxed on an excess EPSP amount under these provisions, he or she would be permitted to deduct that amount from the calculation of taxable income in order to prevent double taxation.

While these provisions should generally not affect EPSPs sponsored by large publicly traded companies, as it is unlikely that any participant will be a specified employee, they may cause unintended consequences for EPSPs sponsored by privately-owned corporations. Many private corporations offer stock to key executives in order to retain top talent. Where the class of shares offered to executives is not widely held, such individuals could, under the proposed legislation, be considered specified employees and, thus, the effectiveness of the EPSP would be undermined. At this stage, we have no information on the willingness of the Minister of Revenue to waive the tax in these types of situations.

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In the case of a person who is allocated an excess EPSP amount in the year, the special return reporting the excess amount and the taxes owing are due on or before the individual's tax return filing deadline for the year. Typically, this will be April 30 of the following year.

EPSPs can continue to be used as part of a company's overall compensation strategy for both key employees and other employees of the business including employees who are also shareholders. For employees who do not meet the definition of a specified employee, no changes have occurred to the taxation of EPSP payments. For specified employees, the amount to be allocated to the employee is restricted to 20% of salary from the employer. This new tax may impact decisions on the salary/dividend mix used by the company and its shareholders if continued use of the EPSP is planned.

An excess amount could result in a payment of tax higher than the amount that would have been paid, had the excess amount been paid as salary. The increased taxes could be particularly significant in Ontario as a result of the new marginal tax rate applicable to taxable income in excess of $500,000. Thus, plan sponsors need to carefully evaluate the amounts allocated to specified employees.

It should be noted that the rules still permit a deferral of tax where the contribution is made by the employer in the following tax year but within 120 days of the employer's year end. Further, no withholding of tax, Canada Pension Plan or Employment Insurance is required for amounts allocated to or paid out of an EPSP.

Retirement compensation arrangements

The August 14, 2012 draft legislation includes:

- New "prohibited investment" and "advantage" rules in respect of an RCA that has a "specified beneficiary".
- A new restriction on RCA tax refunds in circumstances where the RCA property has lost value.

Prohibited investment rule

A new tax equal to 50% of the fair market value of any prohibited investment acquired by an RCA after March 28, 2012 and any asset of an RCA that becomes a prohibited investment after March 29, 2012 will apply. As a general rule, a prohibited investment includes:

- Debt of a specified beneficiary.
- Capital stock or debt of a corporation, partnership or trust in which the specified beneficiary has a significant interest and any entity that does not deal at arm's length with or is affiliated with the specified beneficiary.

A specified beneficiary is an individual who has an interest under the RCA and also has (or had) a significant interest (generally 10% or more) in the issued shares of any class of the capital stock of the employer or a related corporation or a similar percentage interest in a partnership or trust. The interests held by non-arm's length parties will be included in determining whether a beneficiary holds a significant interest.

As a result of these new provisions, where, for example, an owner-manager participates in an RCA, the RCA may not invest in the debt or securities of an entity in which the owner-manager has a significant interest.

This tax will be refundable if the RCA disposes of the prohibited investment by the end of the year following the year in which it was acquired unless any person liable for the tax knew or ought to have known that the investment was a prohibited investment. The prohibited investment is deemed to be disposed of when the investment ceases to be prohibited.

The tax can be waived where the Minister of Revenue considers waiver to be appropriate. Factors that could influence the Minister may include demonstration that the tax was attributable to a reasonable error or that the acquisition of a prohibited investment is also taxable under other provisions of the Income Tax Act.

Advantage rule

The draft legislation also introduces a new tax where an advantage is granted to an RCA, a specified beneficiary or a person who does not deal at arm's length with the specified beneficiary. This special tax will be equal to the fair market value of the advantage and will be payable by the RCA.

The advantage rules are complex and should be discussed in detail with your tax advisor. Below is a high level summary of some of the items that could give rise to an advantage:

- A loan or indebtedness arises that is conditional upon the existence of an RCA (with certain exceptions);
- There is an increase in the fair market value of property held in the RCA and it is reasonable to conclude that the increase is attributable to transactions designed to benefit from the RCA's general exemption from taxation (or certain other provisions of the Income Tax Act) if certain conditions are met;
- A benefit is paid that is income or a capital gain that is attributable directly or indirectly to a prohibited investment;
- An "RCA strip", being the reduction in the fair market value of property held in the RCA where the reduction is a result of a transaction which has as one of its main purposes to enable the specified beneficiary or parties who do not deal at arm's length with the specified beneficiary to use or obtain the benefit of the property without an amount being included in income. An example would be a loan to a specified beneficiary where there is no provision for repayment or a loan to an RCA under which unreasonable interest is paid.

These provisions are attempting to prevent advantages or transactions which would not be offered on the open market.

The definition of "advantage" will generally apply to transactions arising after March 28, 2012. Amending a promissory note or debt obligation to ensure an exemption will be satisfied will be acceptable under the proposed legislation and will not cause the obligation to be "reacquired" by the RCA.

RCA tax refund restrictions

The proposed legislation will restrict the custodian's ability to file an election and collect previously paid refundable tax when the RCA's assets have declined in value, unless the decline in value is not reasonably attributable to prohibited investments or advantages or the Minister of Revenue is satisfied that it is just and equitable to refund the RCA tax.

This measure will apply to elections made in respect of the refundable tax on RCA contributions made after March 28, 2012 and on income earned and gains realized in respect of such contributions.

Looking ahead

The proposed legislation may have a significant impact on participants in EPSPs and RCAs. It is important to consult with your Deloitte Tax advisor in order to ensure that you understand the impact of these provisions and consider appropriate mitigating measures.

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