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Tax Alert — Canada

Finance releases draft legislation relating to retirement compensation arrangements that are secured by letters of credit

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 30 November 2023, Bill C-59, *Fall Economic Statement Implementation Act, 2023*, received first reading in the House of Commons. The bill contains, among other things, certain measures announced in the 2023 federal budget (Budget 2023), including draft legislative proposals relating to retirement compensation arrangements (RCAs), which have been modified since their release on 4 August 2023.[1] These proposed amendments will apply as of 1 January 2024, except where indicated otherwise.

In this Tax Alert, we provide a brief overview of the draft legislative proposals relating to RCAs that are included in Bill C-59.

[1] For more information on the measures included in Bill C-59, see EY Tax Alert 2023 Issue No. 44.

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Background

The proposed changes are relevant to employers who provide supplemental pension benefits to employees outside registered plans, such as registered pension plans (RPPs) and certain other registered plans.

In general terms, an RCA is a type of employer-sponsored arrangement under which the employer makes contributions to a custodian to provide supplemental pension benefits to its employees, typically on termination or retirement. Employers can pre-fund these retirement benefits through contributions to a trust established under an RCA (RCA trust) or they can obtain a letter of credit or surety bond[2] to provide security in the event the employer is not able to pay. With a letter of credit, the employer pays an annual fee or premium to secure or renew the letter of credit, which is treated as a contribution under an RCA. Where a contribution is made to an RCA, refundable tax is imposed at the rate of 50% on contributions to the RCA trust, as well as on all investment income earned by the RCA trust. The refundable tax is generally refunded as the RCA trust pays retirement benefits to the employee.

Budget 2023 proposed to amend the *Income Tax Act* (the Act) so that fees or premiums paid for the purposes of securing or renewing a letter of credit for an RCA that is supplemental to an RPP will not be subject to refundable tax.

Prior to these proposed changes, the employer was required to remit to the Canada Revenue Agency an amount equal to the amount of fees or premiums it paid to acquire or renew a letter of credit as refundable tax. The amount of refundable tax remitted would remain in a refundable tax account until distributions from the RCA trust were made to the employee (or, if the employee died, a surviving spouse or common-law partner, or the employee's estate) or the RCA trust was wound up. However, many employers who use a letter of credit to secure benefit obligations under an RCA do not make distributions of benefits from the RCA trust, but rather pay those benefits directly to the employee from their corporate revenues. Consequently, many RCAs that are secured by a letter of credit have significant balances in their refundable tax accounts, with no practical mechanism for recovery.

To address this issue, Budget 2023 also proposed to amend the Act to allow employers to request a refund of previously remitted refundable tax in respect of fees or premiums paid for letters of credit by RCA trusts, based on the retirement benefits paid directly by the employer. Employers would be eligible for a refund of 50% of the retirement benefits paid, up to the amount of refundable tax previously paid.

[2] The term "letter of credit" is used throughout this Tax Alert to refer to letters of credit and surety bonds.

The details

The draft legislative proposals in Bill C-59 include the addition of the following new definitions in Part XI.3 of the Act:

- Excluded contribution;
- Specified arrangement;
- Eligible employer; and
- Specified refundable tax.

These new definitions operate together to exclude fees and premiums paid for a letter of credit from the calculation of refundable tax and to create a mechanism and a process for claiming a refund of previously remitted refundable tax in respect of these fees and premiums.[3]

Specifically, if a contribution qualifies as an "excluded contribution" and is made on or after 28 March 2023, it will not be subject to refundable tax.[4] If a contribution qualifies as an "excluded contribution" but was made before 28 March 2023, the eligible employer may claim a refund of refundable tax paid on such contribution, up to certain limits, as described in more detail below. Generally, a fee or premium paid to acquire or renew a letter of credit for the purposes of securing retirement benefit payments under an RCA qualifies as an "excluded contribution" if the RCA qualifies as a "specified arrangement". The new definition of "specified arrangement" refers to an RCA that has a primary purpose of providing annual or more frequent periodic retirement benefit payments and that satisfies one of the following conditions:

a) It provides benefits that are paid as supplemental benefits provided under an RPP, a registered retirement savings plan, a deferred profit sharing plan, a pooled registered pension plan, or any combination of these plans; or

b) It substantially complies with the criteria to be registered as an RPP (except for, most notably, the maximum benefit limits prescribed in the *Income Tax Regulations*).[5]

Only an eligible employer or a custodian may claim a refund of previously remitted refundable tax in respect of fees or premiums paid for letters of credit. To claim a refund, an eligible employer or a custodian of the specified arrangement must have paid refundable tax with respect to an excluded contribution made under the arrangement before 28 March 2023. The eligible employer must also file an election with the Minister in prescribed form and manner, and the election must include an "elected amount" that does not exceed the total amount of refundable tax paid with respect to excluded contributions made under the arrangement prior to 28 March 2023. The elected amount is significant because it is factored into the definition of "specified refundable tax", as described in more detail below.

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[3] Once enacted, the definitions of "excluded contribution" and "specified arrangement" will be deemed to have come into force on 28 March 2023.

[4] Once enacted, the amendment to the definition of "refundable tax" to carve out an excluded contribution made on or after 28 March 2023 will be deemed to have come into force on 28 March 2023.

[5] A specified arrangement is also not required to comply with the pension adjustment limits requirement.

An eligible employer or custodian of the specified arrangement that meets the necessary conditions can obtain a refund of the amount claimed on the T3-RCA, *Retirement Compensation Arrangement (RCA) Part XI.3 Tax Return*, for a taxation year. The refund amount cannot exceed the lesser of 50% of all retirement benefits paid in the year directly by the eligible employer for the benefit of beneficiaries whose retirement benefits were secured under the specified arrangement with a letter of credit, and the "specified refundable tax" balance at the end of the taxation year. The "specified refundable tax" is the amount, if any, by which the elected amount exceeds the total of all refund amounts in respect of a preceding taxation year.

Where an amount is refunded to an employer under these new measures, the amount must be included in the employer's income for the taxation year in which the amount was received.

Key takeaways

The draft legislative proposals relating to RCAs in Bill C-59 contain some notable changes to the draft amendments to the Act that were introduced on 4 August 2023. For example, an RCA could now qualify as a "specified arrangement" if, among other requirements, it would "substantially comply" with the prescribed conditions for registration for an RPP (except for, most notably, the maximum benefit limits). The proposed definition of "specified arrangement" included in the draft legislative proposals released on 4 August 2023 contained what appeared to be a higher threshold that required the RCA to meet "all or substantially all" of the prescribed conditions for registration for an RPP (except for, most notably, the maximum benefit limits). Interestingly, this is the second instance in which the government appears to be expanding the scope of these proposed measures. Budget 2023 initially proposed these measures for RCAs that are supplemental to an RPP.

In addition, the draft legislative proposals released on 4 August 2023 defined an "eligible employer" as an employer that, before 28 March 2023, paid an amount under a specified arrangement that is an excluded contribution. The draft legislative proposals in Bill C-59 expand the definition to include an employer that has a predecessor employer that paid an amount, before 28 March 2023, under a specified arrangement that is an excluded contribution. This is a welcome revision to avoid penalizing employers who assumed an RCA secured by a letter of credit in the context of the purchase of a business.

The absence of a practical mechanism for recovery of refundable tax where a letter of credit is used to secure benefits under an RCA has been a longstanding concern for many employers and custodians of RCA trusts. The draft legislative proposals are welcome developments that are expected to make secured RCAs more affordable for employers who use them to provide supplemental pension benefits to employees.

While the draft legislative proposals provide relief from the refundable tax for RCAs secured by a letter of credit, the reporting requirements of subsection 207.7(3) of the Act continue to apply. Therefore, custodians of RCAs secured by a letter of credit will continue to have the obligation to file the T3-RCA, *Retirement Compensation Arrangement (RCA) Part XI.3 Tax Return*.

Learn more

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