Retirement Compensation Arrangements: What Tax Savings?

A lesser known Canadian tax shelter called a Retirement Compensation Arrangement (RCA) has such a complicated cash flow regime that many writers don't even attempt to state how it actually saves tax. Some document how it works, and its ancillary benefits and uses, but its tax savings are not clear. The impression left is that the RCA provides expanded pension tax sheltering for high income earners, something like tax-free growth and a lower withdrawal tax rate.

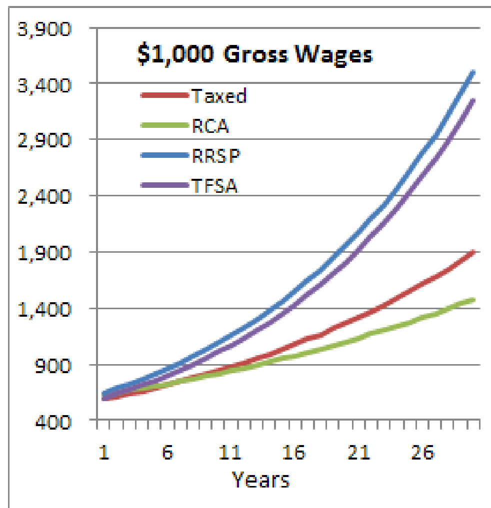
Although various uses are allowed, here I model the most simple: one contribution, made by the employee, and one withdrawal years later. Modeling installments only adds confusion without changing the tax impacts. The original employment compensation is tax deductible for the corporation just like wages would be. The employee funds the RCA with before-tax dollars just like an RRSP. The later withdrawal is taxed at normal rates, just like an RRSP. The weirdness happens in between.

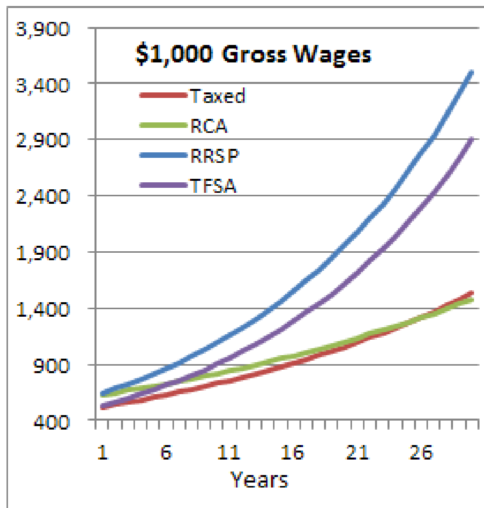
Immediately on funding, half the savings are diverted to the government, to be held until the RCA funds are withdrawn. This means only half the funds are invested to earn profits. It can be thought of as if profits on the total savings are taxed at 50%. Each year, half the RCA's profits are diverted to the same withholding account. That is half the profits earned by half the savings. The effect of this is more difficult to understand, but after the government withholdings are recovered there is no additional impact. Taking the two accounts together (RCA and withholdings), the outcome is the same as if there had been no withholdings from profits.

Normal Acct Taxed 50%			RCA				
			RCA Account			Withholdings	Total
Account boy	After-tax 6% Profits	Year	Account boy	6% Profit	Allocate to w/h	Cumulative eoy	Both boy
1,000	30	1	1,000	30	(515)	515	1,000
1,030	31	2	515	31	(15)	530	1,030
1,061	32	3	530	32	(16)	546	1,061
1,093	33	4	546	33	(16)	563	1,093
1,126	34	5	563	34	(17)	580	1,126
1,159			580				**1,159**

The RCA's 'as if 50%' tax is worse than a normal Taxed account where investment profits would be preferentially taxed at rates lower than 50%, no matter what the tax bracket. This is a drawback for RCAs that must be overcome by some other benefit. Its calculation is the same as for the benefit from tax-free growth in the TFSA and RRSP, only with a negative result. The cost equals the difference between the future values of the after tax savings compounded at the normal after-tax rate of return vs. at the after-50%-tax rate of return.

At withdrawal the funds in the withholdings account (which were never invested) are recovered. The RCA's only tax benefit comes from a possible lower withdrawal tax rate (vs. at contribution). It is calculated the same way as the RRSP's bonus ($ withdrawn * difference in % tax). The RCA's net benefit vs. a Taxed account is the difference between the two offsetting factors.





		Variables
Marginal tax	wages	43.5%
	withdrawals	39.0%
Tax rate on profits		31.4%
Investment returns -nominal		6%

		Variables
Marginal tax	wages	49.5%
	withdrawals	39.0%
Tax rate on profits		37.2%
Investment returns -nominal		6%

The charts above compare outcomes for different accounts. The assumptions on the left reflect someone earning more than will qualify for RRSP contributions. Contributions and profits are in the fourth tax bracket, with draws in the third. The math calculations can be confirmed with my spreadsheet. This RCA is hardly worth the administrative work and requires quick liquidation. The right chart reflects contributions and profits in the top tax bracket, with draws two brackets lower. This RCA outcome is better than the Taxed account and for longer, but is already reduced to a cumulative 16% benefit by the fifth year.

Notice that the 'as if 50%' tax on profits means that the longer savings are in the RCA, the smaller its net benefits. The account is best for a one-off bonus that would otherwise be taxed at top rates; that can be withdrawn quickly at much lower rates. The RRSP and TFSA outcomes benchmark what might be considered normal retirement benefits. Believing the RCA will supply similar 'secure retirement benefits' is a stretch.

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