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Harvey T. Strosberg

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REGISTERED RETIREMENT SAVINGS PLANS  
EMPLOYEE'S PROFIT SHARING PLANS  
DEFERRED PROFIT SHARING PLANS:  
THEIR SCOPE AND RELATIONSHIP  
TO THE INCOME TAX ACT

HARVEY T. STROSBERG\*

*Registered Retirement Savings Plans*

Parliamentary discussion indicates that the registered retirement savings provisions were enacted to fulfill two objectives. The first was to restore an element of fairness or uniform treatment to the taxation of retirement funds. The second was to reinforce the social policy of fostering retirement savings in the private sector.<sup>1</sup>

The mechanics created to implement these objectives are seen in s. 79B of the Income Tax Act.<sup>2</sup> A retirement savings plan is usually a contract or arrangement between a taxpayer<sup>3</sup> and a resident Canadian trust or insurance company.<sup>4</sup> The taxpayer makes periodic payments to the recipient trust or insurance company, which, in consideration for these amounts will at maturity pay the taxpayer an annuity for life. The annuity may be achieved by a contract where a fixed annuity will be paid dependent on contribution.<sup>5</sup> However, arrangements may be made to have monies "invested, used, or

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\*Harvey Strosberg, LL.B., Osgoode Hall Law School, was in the graduating class of 1969.

<sup>1</sup> R.N. Schoepflein, *Taxpayer Participation Under the Registered Retirement Savings Program*, THE CANADIAN JOURNAL OF ECONOMICS AND POLITICAL SCIENCE, Vol. 32 (May, 1966), p. 220.

<sup>2</sup> R.S.C. 1960, c. 148 as amended.

<sup>3</sup> s. 79 B(1)(h)(i).

<sup>4</sup> Information Bulletin No. 13 (Revised) dated September 13, 1967, and published in the Canada Gazette, Part I, September 23, 1967, provides:

These plans may be issued by:

- (a) insurance companies that are licensed to carry on business in Canada,
- (b) Canadian trust companies,
- (c) certain investment companies that sell investment contracts and have been approved by an Order-in-Council and,
- (d) the Annuities Branch of the Department of Labour, hereafter referred to as the issuers.

<sup>5</sup> v. footnote 2.

otherwise applied" through the vehicle of a trust<sup>6</sup> or investment contract.<sup>7</sup> It seems that a taxpayer may contribute as much as he wishes to such a plan. The Act, however, limits his allowable deduction. If the taxpayer is an individual who in that taxation year is a beneficiary under a registered pension plan and whose employer made a contribution to that plan and claimed a deduction under s. 11(1)(g), then the taxpayer in that taxation year may contribute the lesser of 20% of his income or \$1500 less amounts already deducted under the pension plan.<sup>8</sup> It seems, however, that if the taxpayer is a beneficiary under a registered pension plan where the employer funds by way of a lump sum contribution and deducts the same under s. 11(1)(h), the taxpayer is only bound by the above restrictive rates in the year of funding.<sup>9</sup> At other times he may contribute, along with the taxpayers who are not participants under registered pension plans, \$2500 or 20% of his earned income for that taxation year.<sup>10</sup> The deduction may be allowed in a taxation year so long as payment is made within 60 days of that year's end. The basic sweeteners in this concept are:

(1) the deductibility of the premium contribution and

(2) the tax free nature of all earnings during the life of the plan.<sup>11</sup>

The government, however, requires that before one may partake of these benefits the retirement savings plan must be accepted for registration by the Deputy Minister for Taxation in Ottawa.<sup>12</sup> As with all government concepts, certain conditions<sup>13</sup> must be fulfilled as a pre-requisite to registration. The plan must not provide for any benefit before maturity except by way of a refund of premiums.<sup>14</sup> After maturity, benefits may be paid in the form of an annuity to the taxpayer<sup>15</sup> or to the taxpayer and spouse for their joint lives, and to the surviving spouse for his or her life. The annuity may or may not be guaranteed. If, however, the term is guaranteed, the maximum guaranteed term for plans entered into before March 13, 1957, is 20 years and plans entered into after this date, 15 years.<sup>16</sup> The plan may only provide for equal annual or periodic amounts after maturity.<sup>17</sup> No premiums may be payable after maturity.<sup>18</sup> The plan must mature by the time the taxpayer reaches age 71,<sup>19</sup> and must include a proviso that no annuity, in whole or part, may be surrendered or assigned.<sup>20</sup>

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<sup>6</sup> s. 79 B(1)(h)(ii)(A).

<sup>7</sup> s. 79 B(1)(h)(ii)(B).

<sup>8</sup> s. 79 B(5)(a).

<sup>9</sup> Id.

<sup>10</sup> s. 79 B(5)(b).

<sup>11</sup> s. 79 (B)(4).

<sup>12</sup> See footnote 2. Bulletin cited therein sets out mechanics.

<sup>13</sup> s. 79 B(a).

<sup>14</sup> s. 79 B(2)(a)(i).

<sup>15</sup> s. 79 B(2)(a)(ii)(A).

<sup>16</sup> s. 79 B(2)(a)(ii)(B).

<sup>17</sup> s. 79 B(2)(b)(i).

<sup>18</sup> s. 79 B(2)(b)(ii).

<sup>19</sup> s. 79 B(2)(b)(iii).

<sup>20</sup> s. 79 B(2)(c).

The plan may provide for a benefit after maturity by way of dividend;<sup>21</sup> moreover, it may allow the amounts payable to be reduced on a spouse's death, on receipt of an Old Age Pension or on a fluctuation in the value of assets upon which the annuity depends.<sup>22</sup> This allows a plan to provide analysis of and integration with prevailing circumstances to render the most profitable plan for the taxpayer or his surviving spouse. It must also be noted that the plan may be joined with a contract or arrangement which is not a retirement savings plan,<sup>23</sup> e.g., a contract for insurance.<sup>24</sup>

When a taxpayer receives a benefit, except as a return of premium under a plan, he must include the amount received in his income.<sup>25</sup> Thus one may see that the tax shelter offered as a sweetener does not extend to payment out. The implicit assumption is, of course, that the marginal rate at the time of contribution exceeds the marginal rate at time of payment out. This assumption ought to be evaluated in the light of the fact that capital gains are tax free and yet the fund's capital gains are taxed at the individual's marginal rate at time of payment out. Moreover, as dividends are received tax free, the fund does not utilize the 20% tax credit; nevertheless, that portion of the payment out which may be attributed to dividends is also taxed at the individual's marginal rate. Hence, from that portion of the fund the rate of marginal taxation must be 20% lower than at payment in to validate the assumption. Where the contributor receives amounts before maturation by way of a refund of premium, the amount received is not brought into income.<sup>26</sup> However, the taxpayer must pay a flat 15% tax<sup>27</sup> which is withheld and remitted by the plan's administrator.<sup>28</sup> A "refund of premium" is a term of art and is defined<sup>29</sup> as an amount paid or payable under a retirement savings plan on or after the taxpayer's death if the death is prior to the date fixed for the commencement of the annuity. This definition suggests that amounts so received are taxable under the Estate Tax Act.<sup>30</sup>

The Income Tax Act contemplates revision, amendment and substitution to the plan. When this occurs the amended plan must be accepted for registration by the Minister.<sup>31</sup> Registration is dependent on compliance with all the previously listed conditions. If an amended plan fails to comply it is deemed not to be registered retirement savings plan.<sup>32</sup> There is a deemed distribution of the plan's assets which the beneficiary must bring into his

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21 s. 79 B(3)(a).

22 s. 79 B(3)(b).

23 s. 79 B(3)(e).

24 No. 643 v. M.N.R. 1959 D.T.C. 451 (T.A.B.).

25 s. 79 B(b).

26 s. 79 B(7)(a).

27 s. 79 B(7)(b).

28 s. 79 B(7)(a).

29 s. 79 B(1)(f).

30 R.S.C. 1952 c.29, s. 3(i), (j), (k).

31 s. 79 B(8).

32 s. 79 B(8)(a).

income. A 15% tax is withheld. The individual's marginal rate is applied to the amount received. If the marginal rate exceeds 15% a 15% tax credit is given. If, however, the rate is less than 15% no refund is forthcoming. Hence, one sees that the marginal rate is subject to a 15% minimum.

As enumerated above a condition of registration prohibits payment out before maturity. Circumstances, however, may arise before maturity in which the contributor requires money, e.g., sickness. It seems that in such situations the administrator, if he wishes, may make a payment to the contributor by way of loan or refund. Such a payment, it should be emphasized, cannot be made without the administrator's concurrence. All amounts so received will be taxed at the recipient's marginal rate subject to the said 15% minimum.<sup>33</sup>

This conclusion of law raises interesting possibilities for students supported by a working wife whose marginal rate exceeds 15%. The wife should set up a registered retirement savings plan and contribute 20% of her gross earnings to achieve the maximum possible deduction. The plan preferably would be an equity one to increase the possibility of capital gains. The wife's contribution should not reduce her taxable income below 15%. When the wife eventually retires to look after a family the plan would be terminated in the first taxation year that she is a nil wage earner. Thus, all contributions and increments to approximately \$4000 would be freed at a 15% tax cost. This will result in a substantial tax saving.

#### *Illustration I*

gross earnings .....	\$ 6100.00
standard deductions .....	1100.00
taxable income .....	5000.00
tax payable .....	1030.70
maximum contribution to plan .....	1220.00
tax payable .....	711.40
tax savings by joining plan .....	\$ 1030.70
	- 711.40
	<hr/>
	\$ 319.30

Assume that one year later the \$1220 is withdrawn and the contributor has no income in withdrawing year;

15% withheld .....	\$ 183.00
net tax savings .....	\$ 319.30
	- 183.00
	<hr/>
	136.30

<sup>33</sup> CANADIAN TAX REPORTER, Vol. 1A (Don Mills, Ontario, C.C.H. Canadian Ltd.), p. 2610.

These conclusions seem justified when one considers that on a plan's "revision" the amounts received are deemed to be received "otherwise than by way of a refund of premiums" (see s. 79B(8)(b)(ii)). Therefore, by virtue of s. 79B(6) "there shall be included in computing the income of a taxpayer for a taxation year all amounts received by him in the year as a benefit under a registered retirement savings plan, otherwise than by way of a refund of premiums." This, in turn, leads to the conclusion that on receipt of these amounts the standard rules concerning computation of income apply to determine the point at which the 15% withheld becomes a tax credit.

### *Illustration II*

Assuming a wife under the above outlined circumstances had been contributing to this plan for 3 years:

total contributions .....	\$ 3660.00
total tax savings .....	957.90

Assume that the capital appreciation is sufficient to pay the cost of administering the fund.

Assume at this time payment out is made:

15% withheld .....	\$ 549.50
bring into income .....	3660.00
basic deductions .....	1100.00
taxable income .....	2560.00
taxable payable .....	430.40

Therefore, withholding tax is lost and no further tax is payable because the \$549.50 withheld exceeds the \$430.40 tax payable.

Therefore, the tax saved is ..... \$ 408.90

Needless to say, the co-operation of the plan's administrator is a prerequisite to the success of any such utilization. It may be that this utilization may not be easily had. Recall, however, that other contracts may be tied to a plan of this type and insurance companies do love a lawyer's business!

The validity of the above reasoning seems beyond reproach when one realizes that a variation is utilized when a Canadian resident moves "off-shore". The plan is then wound up and, notwithstanding the amount paid to the beneficiary; the only tax paid is the 15% which is withheld. No other tax is owing because the beneficiary is now a non-resident.

A registered retirement savings plan may be constructed with a view to equity investment. There does not appear, however, to be any check on the type or mode of investment. Assume that the taxpayer-contributor has an active business corporation. It clearly would be possible to have the registered retirement savings plan purchase redeemable preferred non-participating shares whose holders could only receive cash dividends. The taxpayer-contributor would hold the common shares and would only be entitled to receive stock dividends. Thus, a dividend history would be achieved on cash dividend declaration to the holders of the preferred shares; however,

since the holder of the preferred shares is the registered retirement trust, there is no immediate tax payable. This dividend history would allow the corporation to create tax paid undistributed income at a 15% cost and return this amount to the common shareholder under s. 105. The benefits of the approach are twofold:

- (1) the value of the preferred shares never increases and
- (2) the amount of the dividends paid into the trust may be either used to purchase more shares or lent to the company.

However, in either case, the money is again available for corporate use.

As there is no limitation on the type of trust investment, there seems to be no reason why mortgages may not be bought. Assume the taxpayer-contributor has just purchased a house and has a \$30,000 mortgage at 9%. He has also contributed \$2,500 to his registered retirement savings plan, availed himself of the \$2500 deduction and thereby saved, for example, \$1000 in taxes. There seems to be no prohibition against the trust governed by the plan taking a second mortgage on the contributor's house. The second mortgage would be for \$2500 and the money advanced would be used to reduce the outstanding first mortgage to \$27,500. The interest on the second mortgage would be 6%. This would be done each year. Eventually, the point would be reached where the first mortgage would be retired and the trust under the registered plan would hold a second mortgage of \$25000 at 6%. This amount could either be paid off or the interest paid each year. Thus, when there is to be a payment out at age 71 the mortgage of \$25000 would be reduced by the hypothetical payment out which would be entered into income and taxed.

In any case, notwithstanding the variation, there is a substantial tax saving. It must also be noted, that a capital gains tax appears imminent. It may very well be that such a tax will not take cognizance of the tax shelter created by a registered retirement savings plan. This is, of course, speculation—but should also be considered in the evaluation of the plan's worth.

### *Employees' Profit Sharing Plan*

An employer's contribution to an employee profit sharing plan is an allowable deduction<sup>34</sup> if the contribution is computed with reference to the employer's business profits<sup>35</sup> and/or the profits of a corporation with whom

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<sup>34</sup> s. 79(4) says deduction is allowable in year of making or within 120 days of the year's end.

<sup>35</sup> s 79(7) provides in effect that even if the amounts payable by the employer are not computed by reference to such profits, an arrangement will qualify under this section if

- (a) the arrangement specifically provides that the payment will be made "out of profits" or
- (b) the employer makes an election in a prescribed manner. The form of the election is prescribed by Part XV of the Income Tax Regulations. Accordingly an employer may, if he desires, have a retirement or other plan for employees which will be subject to s. 79 even though the employer's contribution bears no relation to the profits if it is specifically provided in the plan that such contributions will be made "out of profits." See CCH CANADIAN TAX REPORTER Vol. 1A p. 2589.

the employer does not deal at arm's length.<sup>36</sup> These contributions must be made to a trustee in trust for some or all of the employer's officers and/or employees and/or for the officers and/or employees of the said corporation.<sup>37</sup> This suggests that it is permissible to create plans for particular groups; it seems irrelevant that entrance requirements for membership in such plans may be required.<sup>38</sup> In fact, length of service and position are often used as such requisites.

Beneficiaries under this type of plan are not required by statute to make any contributions;<sup>39</sup> however, terms of many plans do so require and any such employee contribution either by virtue of compulsion under the plan's terms or by way of voluntary participation is not an allowable deduction for the employee for income purposes.<sup>40</sup>

There is no tax payable on the usual taxable earnings of the trust while the trust is governed by an employee profit sharing plan.<sup>41</sup> However, the employer's contribution must be allocated by the trustee, either absolutely or contingently to each beneficiary.<sup>42</sup> Each beneficiary must include in the calculation of his personal tax such an allocation as income, and thus pay tax thereon at his marginal rate.<sup>43</sup>

The type of investment that this trust may make is unrestricted.<sup>44</sup> Therefore, capital gains may be made and dividends received. Capital gains must be allocated although no tax is payable thereon.<sup>45</sup> Similarly, dividends must be allocated and are included in the beneficiaries' computation of tax; however, the beneficiaries may claim the 20% tax credit under s. 38, if the credit would have been applicable, had the dividend been paid directly to the beneficiary.<sup>46</sup>

When a beneficiary receives a payment out of this fund, the amount received, as a general rule, is not taxable in his hands.<sup>47</sup> Tax is payable if the money received is not attributable to:

- (1) the beneficiary's own payment into the fund,<sup>48</sup>

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<sup>36</sup> s. 79(1).

<sup>37</sup> *Ibid.*

<sup>38</sup> v. footnote 33, p. 2589.

<sup>39</sup> Text of speech by L. H. Iron *Pension and Retirement Savings Plan*, REPORT—1967 NOVEMBER CONFERENCE, Canadian Tax Foundation (Don Mills, Ontario, C.C.H. Canadian Ltd., 1968), p. 341.

<sup>40</sup> William M. Mercer, *CANADIAN HANDBOOK OF PENSIONS AND WELFARE PLANS*, 3rd ed., rev. by Laurence E. Coward (Don Mills, Ontario, C.C.H. Canadian Ltd., 1967), p. 115.

<sup>41</sup> s. 79(2).

<sup>42</sup> See footnote 36.

<sup>43</sup> s.79(3).

<sup>44</sup> See footnote 40.

<sup>45</sup> See footnote 43.

<sup>46</sup> s. 79(6)(a).

<sup>47</sup> s. 79(5).

<sup>48</sup> s. 79(6)(a).



- (2) amounts on which tax has been paid by virtue of allocation<sup>49</sup>  
or  
(3) a capital gain.<sup>50</sup>

It should be noted that an anomalous result was seen in *Covey v. M.N.R.*<sup>51</sup> because of this capital gain provision. In *Covey*, the taxpayer, on withdrawing from the fund, took shares. Thus, the trust had not realized any capital gain, with the result that the unrealized capital increment was taxable in the taxpayer's hands. This result is anomalous and should be avoided by proper amendment to the section.<sup>52</sup>

The statutory framework for employee profit sharing plans may lead to serious inequities. This conclusion is buoyed when one realizes that this type of plan is specifically exempted from the provisions of the *Pension Benefits Act*.<sup>52a</sup> The concept of unfettered contingent allocation seems particularly untenable. Conditional allocation may be made on any basis.<sup>53</sup> Frequently, the plan is used as a mechanism to prohibit employee mobility. The employer makes a contribution which is allocated to an employee. However, the allocation will vest in some plans only if the employee is still working for the employer in year 5. The employer gets a deduction in the year of contribution. The employee, conversely, must pay tax in the year of contingent allocation. Thus, it is possible for an employee to have paid tax and never received the money, for example, if the employee leaves in year 4. The Act partially alleviates this inequity by granting a 15% tax credit in the above outlined situation;<sup>54</sup> however, this is a most inexact remedy. Hence, one may see that this approach gravitates towards immobility even amongst dissatisfied employees. This problem is magnified even more when one considers that there is usually no choice for an employee since participation is normally a condition of employment.

This type of plan is an attractive proposition from an employer's viewpoint when one recalls that there is no limitation on the type of investment which the trust may make. Thus, in a widely held corporation the fund may be a means of management's self-perpetuation. The trustee is clearly an appointee of management. Management may instruct the trustee to purchase only the company's voting shares. Hence, management indirectly controls an increasingly larger segment of the outstanding shares. This modus operandi is especially attractive in the light of the above related *Covey* decision which makes it economically unfeasible for a departing employee-beneficiary to take his share allocation with him.

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<sup>49</sup> s. 79(6)(b).

<sup>50</sup> s. 79(6)(c).

<sup>51</sup> 65 D.T.C. 705.

<sup>52</sup> See footnote 39, p. 342.

<sup>52a</sup> The Pension Benefits Act R.S.O. 1965 c. 96 s. 1(h)(iv).

<sup>53</sup> The most common bases are earnings, length of service, and position.

<sup>54</sup> s. 79(6)(c).

Immediate employee tax liability is the distinctive feature of this plan. This liability is the probable practical reason why employers have not used the plan as an effective means of lowering their own current tax liability. That is, as there is no apparent limit to the amount which the employer may contribute out of profits, theoretically, were it not for the immediate employee tax liability, employers could contribute on improbable contingencies, e.g. that the employee continue working until age 90. However, there may be no reason why this could not in fact be done in very low paying high employee turn-over industries. The employer could allocate to the employee on the basis of some remote contingency. The employee would have to bring this amount into income at his marginal rate. However, so long as his marginal rate is below 15% the employee would be ahead as on the divesting of the contingency he would get a 15% government tax credit. The employer would, of course, provide that on the lapsing of the contingency the money would revert in the employer. Clearly, the employer would have to bring this into income at this later date. Of course, this approach runs afoul of the plan's criticism that employees are not left with enough to meet their current living expenses; nevertheless, from the employer's point of view, tax deferred is tax saved.

Most certainly, lawyers could institute this plan for their employees. This conclusion seems tenable when one realizes that s. 79 speaks of "business" and "business" by virtue of s. 139(1)(e) includes "a profession". Query whether, if a wife worked in her husband's office, an allocation under a profit sharing plan which was "included in computing her income for a taxation year" would escape the deadly tentacles of attribution which seems dependent on the scope of "remuneration" under s 21(2). The consensus seems to be that s. 21(2) is still applicable.

#### *Registered Deferred Profit Sharing Plan*

An employee profit sharing plan becomes a deferred profit sharing plan on registration.<sup>55</sup> Regulation 1501 requires that the application be made by forwarding by registered mail to the Deputy Minister of Revenue at Ottawa, a letter from the trustee and the employer applying for registration, accompanied by a copy of the agreement and any supplementary agreement setting out the plan. If the employer is a corporation, the application must also be accompanied by a resolution of the directors authorizing such application to be made.<sup>56</sup>

An employer may elect to have an arrangement qualify as a profit sharing plan even if the computation of the contribution is not based strictly on profits. All that is required is that the phrase "out of profits" appears in the plan.<sup>57</sup> This presumably qualified savings or thrift plans where the employer merely contributes a stated percentage of the employee's contribution.<sup>58</sup>

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<sup>55</sup> s. 79 C(1)(a).

<sup>56</sup> See footnote 33, pp. 2613-15.

<sup>57</sup> s. 79 C(15).

<sup>58</sup> See footnote 39, p. 342.

Acceptance for registration is conditional on the plan complying with certain guidelines. These guidelines attempt to preclude the trust fund from being transferred back to the contribution corporation through the acquisition, for instance, of the company's non-cumulative redeemable preferred shares.<sup>59</sup>

Necessarily, conditions require the trustee to allocate employer contributions,<sup>60</sup> income, capital gains and losses to the employee-beneficiary within 90 days after the year end;<sup>61</sup> these allocations must vest absolutely within 5 years.<sup>62</sup> The beneficiary must not be able by virtue of any provision to surrender or assign all or any segment of his benefits under the plan.<sup>63</sup> It should be noted that the trustee must either be a Canadian trust company or three individuals resident in Canada.<sup>64</sup> If the employer is not a public corporation at least one of the trustees must be independent of the operations of the company and should not be a shareholder.<sup>65</sup> The trustee(s) must inform in writing all new beneficiaries of their rights.<sup>66</sup> This is to alleviate the problem of employee ignorance of the plan's existence and terms of vesting.

The distinguishing feature of this plan is the provision for lump sum payments out; these payments must be made within 90 days of death,<sup>67</sup> cessation of employment,<sup>68</sup> attainment of age 71<sup>69</sup> or the winding up of the plan.<sup>70</sup> However, the plan may provide for an employee election that would have benefits paid in equal annual installments over a period not exceeding 10 years<sup>71</sup> or an election to have the monies used to purchase an annuity to commence no later than at age 71 with a guaranteed term, if any, not to exceed 15 years.<sup>72</sup> It seems that there is no restriction as to who may be named as a joint beneficiary under this annuity; this distinguishes this annuity from an annuity governed by a registered retirement savings plan.

The plan must comply with the above enumerated conditions and the departmental rules which require that the plan define normal retirement age and prohibit divesting because of dismissal for cause.<sup>73</sup> There is no tax payable on the income of the trust<sup>74</sup> if there is this said compliance, so long

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<sup>59</sup> (1966) 9 CAN. B. J. 247.

<sup>60</sup> s. 79 C(2)(a).

<sup>61</sup> s. 79 C(2)(h).

<sup>62</sup> s. 79 C(2)(i).

<sup>63</sup> s. 79 C(2)(e).

<sup>64</sup> s. 79 C(2)(g).

<sup>65</sup> See footnote 40, p. 119.

<sup>66</sup> s. 79 C(2)(j).

<sup>67</sup> s. 79 C(2)(k)(i).

<sup>68</sup> s. 79 C(2)(k)(ii).

<sup>69</sup> s. 79 C(2)(k)(iii).

<sup>70</sup> s. 79 C(2)(k)(iv).

<sup>71</sup> s. 79 C(2)(k)(v).

<sup>72</sup> s. 79 C(2)(k)(vi).

<sup>73</sup> See footnote 65.

<sup>74</sup> s. 79 C(6)(a).

as 90% of the trust's income was derived from sources in Canada.<sup>75</sup> The employer's contribution is deductible in the computation of his tax. The maximum deductible contribution attributable to a specific employee is the lesser of \$1500 minus any amounts claimed by the company as a contribution for that employee's current service under a registered plan<sup>76</sup> or 20% of the employee's salary.<sup>77</sup>

The employee may be allowed or required to make contributions to the plan. However, the employee's contribution is not an allowable deduction in the computation of his tax, but it is therefore tax free on payment out.<sup>77a</sup> The beneficiary must include in his income all amounts received under the plan.<sup>78</sup> However, if a single payment is taken the beneficiary may elect to pay a special tax under s. 36 in lieu of his personal tax. Moreover, if a beneficiary avails himself of the opportunity to instruct the trustee to use this money to purchase an annuity as outlined above, the money so transferred is deemed an allowable deduction in the computation of the beneficiary's tax.<sup>79</sup>

As has been pointed out, an employee profit sharing plan on registration becomes a deferred profit sharing plan. On acceptance for registration the taxation year of the employee profit sharing plan is deemed to have ended immediately before the plan was registered.<sup>80</sup> Thus, since an employee profit sharing plan may become a deferred profit sharing plan, one may appreciate the possibility that an employee may have paid tax on certain amounts allocated to him under the employee profit sharing plan. On payment out, if the general rule of inclusion into income was applied, there would be double taxation. To eliminate this possibility any amounts which were allocated to the employee while the plan was an employee profit sharing one by virtue of employer's contributions,<sup>81</sup> earnings,<sup>82</sup> capital gains<sup>83</sup> and personal contributions,<sup>84</sup> may be claimed as an allowable deduction on payment(s) out to their aggregate under the deferred profit sharing plan.

This above approach illustrates the main limitation in the taxation of deferred profit sharing plans. On payment out capital gains which are usually tax free are taxed (However, capital losses are considered). Similarly, dividends are taxed at full value while a 20% tax credit under s. 38 would usually be available.<sup>85a</sup>

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<sup>75</sup> s. 79 C(6)(b).

<sup>76</sup> s. 79 C(7)(b).

<sup>77</sup> s. 79 C(7)(c).

<sup>77a</sup> s. 79 C(11).

<sup>78</sup> s. 79 C(9).

<sup>79</sup> s. 79 C(9)(b).

<sup>80</sup> s. 79 (8).

<sup>81</sup> s. 79 C(10)(a)(i).

<sup>82</sup> *Id.*

<sup>83</sup> s. 79 C(10)(a)(ii).

<sup>84</sup> s. 79 C(10)(a)(iii).

<sup>85a</sup> Laurence E. Coward, *PENSIONS IN CANADA; A COMPENDIUM OF FACTS AND OPINION* (Don Mills, Ontario, C.C.H. Canadian Ltd., 1964), p. 181.

Clearly, the relevant legislation is attempting to prohibit the utilization of the deferred profit sharing plan mechanism as a vehicle of tax avoidance. Therefore, as a general rule, where funds or property are appropriated in any manner whatsoever for the benefit of a taxpayer who is the employer-contributor, the amount or value of that appropriation must be brought into income by the taxpayer. There are exceptions to the general rule where the appropriation was to buy shares of the company or there is an isolated loan repaid within one year.<sup>85</sup> Similarly, where the trust governed by this type plan disposes of property at less than market value or buys property for more than market value, the difference must be included in the benefiting taxpayer's income as if the amount which represents that difference were received by the taxpayer as a beneficiary under the plan.<sup>86</sup>

The means of prohibiting tax avoidance through this type plan is illustrated by *Hamilton Motor Products Ltd. v. M.N.R.*<sup>87</sup> The facts were as follows:

- (1) on September 23, 1963, the company applied for registration of its deferred profit sharing plan;
- (2) on September 30, 1963, the M.N.R. requested certain revisions;
- (3) on October 4, 1963, the M.N.R. approved the plan effective September 23, 1963;
- (4) on October 4, 1963, the company sold all its assets and discharged all of its employees except the principal shareholder and his brother;
- (5) prior to this, on September 14, 1963, the company allocated \$103,500 to its employees (calculated at \$1500 per employee);
- (6) this amount was paid to the trustee on September 27, 1967;
- (7) on discharge the employees were paid \$19,000;
- (8) in December, 1963, the remaining amount was re-allocated by the trustee under the terms of the trust to the principal shareholder and his brother, the only remaining employees.

The Exchequer Court held, inter alia, that s.137(1) was applicable in that the appellant company never intended to set up a bona fide profit sharing plan; that the transaction was a sham and was intended to artificially reduce income.<sup>88</sup> It should be noted that this plan only allowed monies to vest at age 65. This vesting condition was quite valid prior to the 1966 amendment which required vesting within 5 years. Under the prior legislation there were wide areas in which there were no guidelines, for example, vesting contingencies. Under these circumstances one could clearly understand the need for the application of s.137(1). However, under the present legislation the variables are closely contained, investment is regulated and there is wide power for regulation which, however, did exist prior to 1966. I submit that

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<sup>85</sup> s. 79 C(12).

<sup>86</sup> s. 79 (C)(17).

<sup>87</sup> [1967] C.T.C. 338.

<sup>88</sup> Id. 345.

in this present framework, there is no need for the application of s.137(1) and its use in these circumstances should be abandoned. I make this submission with the knowledge that the authorities concerning s.137(1) negate any such limitation.

The case of *M.N.R. v. Lade*<sup>89</sup> presents an interesting possibility. The facts are as follows:

- (1) the company instituted a stock purchase plan;
- (2) the company contributed a monthly amount equal to 50% of the employee's contribution plus an annual contribution based on profits if the profits exceeded a certain percentage of investment capital;
- (3) during 1959 the company made monthly payments but no annual payments;
- (4) Mr. Lade was allocated \$315 of the company's contribution;
- (5) the M.N.R. said this amount was taxable in the taxpayer's hands because the plan was an employee profit sharing plan.

The Supreme Court of Canada held, Cartwright J. (as he then was) speaking for the court that:<sup>90</sup>

. . . An arrangement under which the amount of payments made by an employer is fixed by the amount contributed by his employees, regardless of whether he does or does not make a profit, is not brought within S.79(1) merely because the employer agrees to make an additional payment based on profits exceeding a fixed ratio.

The ratio of the *Lade* case is that if a savings plan is not registered as a deferred profit sharing plan nor an election made to qualify the plan as an employee profit sharing plan by using the phrase "out of profits", the employer's contribution to the plan is not taxable on allocation to the employee. However, the case did not state whether the employer was denied a deduction for his contribution. Therefore, if a savings plan is not an employee profit sharing plan it appears that it can obtain the identical tax treatment as a deferred profit sharing plan without registering and without the restrictions on investment and limitation on deductibility of the employer's contributions. This is so, provided the employer's contributions would be deductible as an ordinary business expense.<sup>91</sup>

Any such conclusion must be evaluated in the light of the recent case *Pattons & Baldwins Ltd. v. M.N.R.* [1969] T.A.B.C. 221. Pattons established a pension plan in 1948. Contributions in 1961, 1962 and 1963 were not allowed as deductions on the grounds that they were not paid pursuant to a registered pension plan in accord with s.11(1)(g). Snider at p. 222 said:

. . . the fact remains that the Act requires any pension plan to be registered before [a deduction is allowed] . . . Counsel for the appellant suggested that the desired deduction might be allowed under the general law relating to deductions by com-

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<sup>89</sup> [1965] D.T.C. 5297.

<sup>90</sup> *Id.*, 5299.

<sup>91</sup> See footnote 39, p. 344.

mercial enterprises, as appears to have been done in the United Kingdom for instance. In my view, though, the explicit wording of the above-mentioned sections [S.11(1)(g) and S.139(1) (ahh)] precludes following that procedure.

The *Pattons* case rests on the footing that the specific excludes the general in income tax matters. This philosophy is clearly at variance with the above suggested opening in the *Lade* case and would likely hold sway.

### *Taxes On Deferred Profit Sharing Plans and Revoked Plans*

In 1966 amending legislation was introduced to curtail prevalent abuses in relation to the fund's investment practices. A tax is imposed on the acquisition of non-qualified<sup>92</sup> investments and on the utilization of trust property as security for a loan.<sup>93</sup> The trustee must pay a tax equal to the cost to the trust of the non-qualified investment, or equal to the market value of any property used as security for a loan, within 10 days of acquisition.<sup>94</sup> On disposition the tax is refundable upon application; however, the net loss sustained by the trust in consequence of its using the property as security, but not as a result of a change in the fair market value, must be deducted and forfeited.<sup>95</sup> Excessive forfeitures and non-conforming dispositions of non-qualified pre-December 1966 investments are also taxed.

A non-qualified investment is any property which is not a qualified investment.<sup>96</sup> A qualified investment means, *inter alia*:

- (1) money, including balances in a bank to which the Bank Act or the Quebec Savings Banks Act applies.<sup>97</sup> This, therefore, would not include deposits with a trust company or other "near-banks" such as credit unions;<sup>98</sup>
- (2) bonds, debentures, notes, mortgages or similar obligations issued by:
  - (a) the Government of Canada,
  - (b) the government of a province,
  - (c) a municipality,
  - (d) a corporation or entity 90% of whose shares or capital is owned by any of the above, or
  - (e) an educational institution or hospital where repayment is guaranteed by a provincial government;<sup>99</sup>
- (3) bonds, debentures, notes or similar obligations of a corporation listed on a prescribed stock exchange in Canada other than those of the employer, or a corporation with whom the employer does not deal at arm's length;<sup>100</sup>

<sup>92</sup> s. 105 K(1)(a).

<sup>93</sup> s. 105 K(1)(b).

<sup>94</sup> See footnote 40, p. 118.

<sup>95</sup> s. 105 K(5).

<sup>96</sup> s. 105 Q(d).

<sup>97</sup> s. 105 Q(e)(i).

<sup>98</sup> See footnote 33, pp. 3067-72.

<sup>99</sup> s. 105 Q(e)(ii).

<sup>100</sup> s. 105 Q(e)(iii).

- (4) shares listed on a prescribed stock exchange in Canada<sup>101</sup> including shares of the employer corporation or a corporation with whom the employer does not deal at arm's length;<sup>102</sup>
- (5) shares of a S.69 investment company;<sup>103</sup>
- (6) equity shares of employer corporations which made payments to the trustee for benefit of employee-beneficiaries before the trust acquired the shares, provided that:
  - (a) there are no restrictions on share transfer,
  - (b) in 4 of the last 5 taxation years the corporation paid a 4% dividend, calculated by comparing the dividend to the share cost, or
  - (c) earnings were at least 4% per share, calculated by assuming each share had a cost equal to the trust's per share cost.<sup>104</sup>
- (7) guaranteed investment certificates issued by a trust company incorporated under the laws of Canada or a province;<sup>105</sup>
- (8) shares listed on a prescribed foreign exchange and not listed on a prescribed Canadian exchange to a maximum of 10% of the cost to the trust of all property held by it immediately before acquisition.<sup>106</sup>

It should be noted that the prescribed Canadian stock exchanges are:

Calgary Stock Exchange  
 Canadian Stock Exchange  
 Edmonton Stock Exchange  
 Montreal Stock Exchange  
 Toronto Stock Exchange  
 Vancouver Stock Exchange  
 Winnipeg Stock Exchange<sup>107</sup>

In addition, an acquisition of an interest under a life insurance policy is deemed to be a qualified investment if it meets the following criteria:<sup>108</sup>

- (1) the trust is the only person entitled to any rights or benefits under the policy;<sup>109</sup>
- (2) the cash surrender value of the policy (exclusive of accumulated dividends) is, or will be, at a time before the 71st birthday of

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<sup>101</sup> s. 105 Q(e)(iv).

<sup>102</sup> See footnote 98.

<sup>103</sup> s. 105 Q(e)(v).

<sup>104</sup> s. 105 Q(e)(vi).

<sup>105</sup> s. 105 Q(e)(vii).

<sup>106</sup> s. 105 Q(e)(ix).

<sup>107</sup> Regulation 3200; Regulation 3201 sets out the foreign stock exchanges prescribed for the purposes of s. 105Q.

<sup>108</sup> s. 105 K(a) and (b).

<sup>109</sup> s. 105 K(6)(c).



the insured beneficiary, not less than the maximum total amount (exclusive of accumulated dividends) payable by the insurer under the policy;<sup>110</sup>

- (3) the total premiums payable in a year must not exceed the aggregate which would have been calculated had the annual premium been paid monthly.<sup>111</sup>

Thus, if a life insurance policy meets the above requirements it is a qualified investment. However, if it does not meet the above qualifications it may be a qualified investment so long as the total of all payments under insurance policies does not exceed 25% of the employer's yearly contribution to the trust.<sup>112</sup> It should be noted that this saving approach will either qualify all the premiums which failed to qualify under the above outlined criteria or it will qualify none of them.<sup>113</sup>

A tax is imposed on all property held after December 21, 1966, which is deemed non-qualified. The tax is calculated with reference to an "initial base." "Initial base" is defined as the aggregate of the value of all initial non-qualified investments held by the trust when the investment is valued at the lower of cost or market value on December 21, 1966.<sup>114</sup> This tax was created to encourage rapid divestiture of non-qualified holdings. The computation may best be explained with reference to the following example:

initial base .....	\$1,000,000
dispositions in 1967 .....	50,000
dispositions in 1968 .....	250,000
dispositions in 1969 .....	650,000
dispositions in 1970 .....	30,000

In 1967, the tax payable was an amount equal to an amount by which 20% of the initial base exceeded the proceeds of disposition of its initial non-qualified investments.<sup>115</sup>

initial base .....	\$1,000,000
20% .....	200,000
<hr/>	
dispositions .....	\$ 50,000
<hr/>	
	50,000
<hr/>	
tax payable .....	200,000
	- 50,000
<hr/>	
	\$ 150,000

<sup>110</sup> s. 105 K(6)(d).

<sup>111</sup> s. 105 K(6)(e).

<sup>112</sup> s. 105 K(7).

<sup>113</sup> See footnote 33, p. 3070.

<sup>114</sup> s. 105 Q(c).

<sup>115</sup> s. 105 L(1)(a).

In 1968, the tax payable was an amount equal to an amount by which 40% of the initial base exceeded the aggregate of proceeds of disposition from December 21, 1966 to December 31, 1968 and taxes payable.<sup>116</sup>

initial base .....	\$1,000,000
40% .....	400,000

dispositions .....	\$ 50,000
	250,000

taxes paid .....	300,000
aggregate .....	150,000

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\$ 450,000

therefore since \$450,000 > \$400,000

taxes payable .....	0
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A refund<sup>117</sup> is available if the aggregate of

all taxes paid .....	\$ 150,000
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exceeds the aggregate of

(i) all refunds .....	0
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(ii) initial base .....	\$1,000,000
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minus proceeds of disposition ....	300,000
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700,000

refund .....	0
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<sup>116</sup> s. 105 L(1)(b).

<sup>117</sup> s. 105 L(2).

In 1969, the tax payable is an amount equal to an amount by which 60% of the initial base exceeds the aggregate of proceeds of disposition from December 21, 1966 to December 31, 1969 and taxes payable.<sup>118</sup>

initial base .....	\$1,000,000
60% .....	600,000

dispositions .....	\$ 50,000
	250,000
	650,000

taxes paid .....	950,000
	150,000

\$1,100,000

therefore since \$1,100,000 > \$600,000

taxes payable .....	0
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A refund is available if the aggregate of

all taxes paid .....	\$ 150,000
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exceeds the aggregate of

(i) all refunds .....	0
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(ii) initial base .....	\$1,000,000
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minus proceeds of disposition ..	950,000
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50,000

refund .....	\$ 100,000
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<sup>118</sup> s. 105L(1)(c).

In 1970, the tax payable is an amount equal to an amount by which 100% of the initial base exceeds the aggregate of the proceeds of disposition from December 21, 1966 to December 31, 1970 and taxes payable.<sup>119</sup>

initial base .....	\$1,000,000
100% .....	1,000,000
dispositions .....	\$ 50,000
	250,000
	650,000
	30,000
	980,000
taxes paid .....	150,000
	\$1,130,000
therefore since \$1,130,000 > \$1,000,000	
taxes payable .....	0

A refund is available if the aggregate of

all tax paid exceeds the aggregate of .....	\$ 150,000
(i) all taxes paid exceeds the aggregate of \$	150,000
(ii) initial base ....	\$1,000,000
minus proceeds	
of disposition .....	\$ 980,000
	20,000
	120,000
refund .....	\$ 30,000

As may be seen from above, the trust paid \$150,000 in tax and recovered on application \$130,000. Thus, there was a loss of interest and \$20,000. This loss arose because:

- (1) all the initial base property was not disposed of or
- (2) the property was disposed of at a price lower than the price of valuation in 1966 or
- (3) a combination of (1) and (2).

A tax is also payable on "amounts forfeited" in a trust governed by a deferred profit sharing plan; "amount forfeited" is a term of art and is defined as the aggregate of each amount which is reallocated by virtue of a person ceasing to be a beneficiary under the plan.<sup>120</sup> This tax aims to prohibit the employer from utilizing the 5 year contingent vesting provision as a mode of tax deferral; deferral might be accomplished by instituting conditions which are unreasonable in view of the specific employer's business and/or work force. These conditions could result in the employer's contribution which

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<sup>119</sup> s. 105 L(1)(d).

<sup>120</sup> s. 105 N(3).

was deducted in year 1, failing to vest in year 5 and being reallocated to the employer at that time. Thus, the employer would have effectively avoided the tax on that amount for 4 years.

The tax is 50% of the amount, if any, by which the amount forfeited in the trust in the year exceeds the aggregate of:<sup>121</sup>

- (1) the amounts included in the employer's income by virtue of an appropriation of trust property for the employer's benefit other than on account of purchase of capital stock, or an isolated repaid loan within the taxation year,<sup>122</sup> and
- (2) the aggregate amount in respect of all employees where the amount for each employee-beneficiary is determined as the lesser of:
  - (a) such part of the forfeited amount that was reallocated to the employee in the year or within 90 days of its end,<sup>123</sup> or
  - (b) the amount obtained by multiplying \$2000 by the number of years the employee was a beneficiary under the plan or its antecedent,<sup>124</sup> minus:
    - (i) the amount of the employer's allowed deduction by virtue of his contribution to the plan, on behalf of the employee benefiting from the reallocation, in the year of reallocation and in all previous years;<sup>125</sup>
    - (ii) all amounts reallocated to the employee in previous years;<sup>126</sup> and
    - (iii) amounts forfeited before December 21, 1966 which have been reallocated to the employee.<sup>127</sup>

The standard in the forfeiture tax computation is \$2000. From this the maximum allowable employer deduction-contribution of \$1500 is subtracted. Thus, the fund may reallocate a minimum of \$500 to each employee-beneficiary per year without tax sufferance. This amount may increase by the difference between the actual employer contribution (usually on the basis of 20%) and the \$1500 maximum. It should be noted, however, that amounts which are attributed to fund earnings are not included in the computation of this tax.

A reduction in the general level of forfeiture may be necessary in certain situations when one considers that the allowable maximum forfeiture is reduced by all forfeitures made to date which were not previously taxed, including forfeited fund earnings of pre-December 21, 1966 vintage.

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<sup>121</sup> s. 105 L(1)(a).

<sup>122</sup> s. 105 N(1)(b).

<sup>123</sup> 105 N(2)(a).

<sup>124</sup> s. 105 N(3)(b)(i).

<sup>125</sup> s. 105 N(2)(b)(ii).

<sup>126</sup> s. 105 N(2)(b)(iii).

<sup>127</sup> s. 105 N(2)(b)(iv).

*Recommendations of the Carter Report*<sup>128</sup>

The report eliminates the distinction between the various plans and contemplates one set of requirements for all registered plans.<sup>129</sup> The Report recommends:

- (1) All contributions to registered plans would be an allowable deduction in the computation of the contributor's taxes.<sup>130</sup>
- (2) These contributions would cease to be an allowable deduction when the employee has benefits sufficient to provide him with the equivalent of a single life annuity of \$12,000 guaranteed for 10 years payable at age 65.<sup>131</sup>
- (3) The ceiling for a family unit would be higher; it would be the equivalent of a joint and survivor life annuity of \$12,000 per annum for the two spouses, without a guaranteed period commencing when the elder spouse attained age 65.<sup>132</sup>
- (4) Excess amounts in existing plans would neither be forced to be paid out nor included in beneficiaries' income; however, no further deductions would be allowed.<sup>133</sup>
- (5) Registered funds' earnings would be tax free; moreover, these funds would be able to claim refunds by way of integration at 50%.<sup>134</sup>
- (6) Employer's contributions and trust income in excess of an amount necessary to provide the appropriate annuity would be required to be attributed or distributed to the beneficiary<sup>135</sup> and taxable in his hands.
- (7) Benefits paid to beneficiaries at maturity would be taxable at marginal rates.<sup>136</sup> A special tax of at least 15% would be levied on all withdrawals prior to age 60, otherwise than on death.<sup>137</sup>
- (8) Any unregistered plan would be regarded as a conduit to the beneficiaries. Employers' contributions and trust earnings would be notionally included in the employees' income and taxed at the appropriate marginal rate.<sup>138</sup>

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<sup>128</sup> REPORT OF THE CANADIAN ROYAL COMMISSION ON TAXATION, 6 vols. (Ottawa, Queen's Printer, 1966).

<sup>129</sup> *Id.*, Vol. 3, p. 421.

<sup>130</sup> *Id.*, 422.

<sup>131</sup> *Id.*, 423.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*, 431.

<sup>134</sup> *Id.*, 422.

<sup>135</sup> *Id.*, 423.

<sup>136</sup> *Id.*, 426.

<sup>137</sup> *Id.*, 427.

<sup>138</sup> *Id.*, 421.

*Comments on Carter and Conclusion*

The evil of tax deferral is the foundation upon which Carter has constructed his recommended structure. To evaluate this recommended structure it is therefore necessary to ascertain whether there is tax deferral and if tax deferral exists, whether it is evil.

I submit that tax deferral usually connotes wilful postponement. However, for the majority of employee-beneficiaries there is no choice involved. Membership in a deferred profit sharing plan is usually a condition of employ. Employees are not able to increase their present take home pay by opting out of the plan. In view of this factor, I fail to discern any wilful postponement. Moreover there is no tax deferral of any sort in an employee profit sharing plan.

Even if one assumes that tax deferral exists, an assumption supportable by viewing the operative effects of registered retirement savings plans, I submit that the deferral is not evil. The government and even the Carter Report have concluded that savings for later years must be promoted in the private sector. This social policy decision led to a modified tax deferral program. In view of this social decision, I seriously question whether I as a Canadian citizen wish to have the Government legislate the extent to which I may provide for my retirement.

Carter speaks of a \$12,000 annuity. One can appreciate that an individual who joins the work force at 20 may have accumulated a sufficient base by the time he is aged 40. At this point Carter recommends that any further employer contributions must be brought notionally into income and taxed. I submit that this fails to take cognizance of the likelihood that the employee may have to reduce basic consumption to meet this tax increment, a situation which clearly will arise amongst salaried wage earners.

Moreover, this approach fails to achieve the Report's avowed objection of equality and neutrality amongst taxpayers. For example, an employee may invest an inheritance in an annuity which will pay him \$12,000 for 10 years commencing at age 65. On the basis of Carter's recommendations that employee and a fellow employee, who do the same job and earn the same hourly wage, will take home different amounts. This possible inequity between collateral individuals is surely contrary to the above avowed principles.

I would agree, however, with the Report's recommendation that the differences between the plans be eliminated. There seems to be no adequate or rational explanation for the framework as it now stands. I would also agree that there should be some limitation to the amount of deductible contributions. However, as stated above, I cannot agree with the mode of instituting the ceiling.