



Report

For members of the Conference for Advanced Life Underwriting

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Employees Profit-Sharing Plans¹

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General

The use of employees profit-sharing plans ("EPSPs") in owner-manager remuneration planning has become very common. Accordingly, the purpose of this article is to comment on various issues that must be reviewed to ensure technical integrity when utilizing EPSPs in owner-manager remuneration planning.

Definition of EPSP

An EPSP³ is defined to be an arrangement under which payments computed by reference to an employer's profits from the employer's business (or a corporation that does not deal at arm's length with the employer) are required to be made by the employer to a trustee under the arrangement for the benefit of employees⁴ of the employer or of a corporation with which the employer does not deal at arm's length. The EPSP also allows flexibility for employers to share profits with all or only a designated group of employees.⁵ In addition, the CRA has recently stated that a trust established for the benefit of employees *cannot* be a

beneficiary of an EPSP since such a trust will not meet the definition of an employee.⁶ The CRA has also commented that an arrangement set up for the benefit of the employer's children where rights under the arrangement will be contingent on non-employment-related conditions would likely *not* be considered an EPSP since the CRA would view the non-employment conditions to imply the arrangement to *not* be for the benefit of the employees.⁷

The definition of an EPSP also requires that the trustee of the EPSP annually allocates to the beneficiaries all amounts (i.e. before December 31 of each calendar year) received by the EPSP from the employer, or from a corporation with which the employer does not deal at arm's length, any profits from property realized by the trust, and any capital gains or losses of the trust.⁸ The employee beneficiary of the EPSP includes the amounts in his or her income that are contingently, or absolutely, allocated to the employee by the trustee of the EPSP at any time in the year.⁹

An EPSP trust is an *inter-vivos* trust.¹⁰ Normally, any income realized by an *inter-vivos* trust would be subject to

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the highest rate of tax on such income.¹¹ However, no tax is payable by a trust on the taxable income of the trust for a taxation year throughout which the trust is governed by an EPSP, as outlined in subsection 144(2) and paragraph 149(1)(p) of the Act.

One key component that has to be met with respect to the definition of EPSPs is that the payments which are required to be made by the employer to the trustee must be computed by reference to an employer's profits from the employer's business. In the absence of certain relieving provisions, one could speculate as to what the phrase "profits" means. For example, does "profits" mean profits as outlined in section 9 of the Act? Must profit be calculated using generally accepted accounting principles? Alternatively, must the principles as outlined in recent Supreme Court of Canada cases dictate the computation of profit? For example, *Canderel Ltd. v. Her Majesty The Queen* [98 DTC 6100], *Toronto College Park Ltd. v. Her Majesty The Queen* [98 DTC 6088], and *IKEA Ltd. v. Her Majesty The Queen* [98 DTC 6092], indicated that the determination of profit is a question of law not to be delegated to the accounting profession. In many cases, the profit will be computed using the same principles as generally accepted accounting principles as set out in the Canadian Institute of Chartered Accountants CICA Handbook — however, this is not always the case.

One can therefore expect that it would become a question of fact as to whether or not a particular payment from an employer to an EPSP would be considered to be by reference to the employer's profits. The CRA provides its views on this topic in paragraph 2 of Interpretation Bulletin

IT-280R which states that contributions computed by reference to profits have to be expressed as a percentage of profits for the year and the minimum contribution permitted cannot be less than 1% of the profits. Paragraph 3 of IT-280R also states that the Supreme Court of Canada decision of *Lade v. The Minister of National Revenue*¹² is the authority for the requirement that employer contributions that are made to an EPSP cannot be dependant upon factors or conditions other than profits. For example, the CRA takes the position that a plan that provides that payments will be made by an employer only after contributions have been made by the employee members of the plan or that provides that the employer's contribution will be based on a percentage of employee contributions will *not* meet the requirements of subsection 144(1).

Subsection 144(10) of the Act is a provision that will deem an arrangement under which an employer makes payments to a trustee whereby the arrangement specifically provides for payments to be made "out of profit" to have met the requirement that payments are computed by reference to the employer's profits to the extent that the employer elects in prescribed manner.¹³ Such a deeming provision can provide considerable flexibility and a relieving opportunity where the trustee of the EPSP does not want to be constrained by an otherwise rigid formula. The election will allow a plan to qualify as an EPSP even though the payments are not computed by reference to profits if the payments are limited by the level of profits.¹⁴

Deductibility of Employer Contributions to an EPSP

An amount paid by an employer to a trustee under an EPSP is deductible by the employer if the payment is made during the year, or is made within 120 days after the taxation year to the extent that it was not deductible in computing income for a previous taxation year.¹⁵ As compared to a bonus that would otherwise be paid to the individual shareholder, the bonus payable must be paid within 179 days of the employer corporation's taxation year-end in order to be deductible.¹⁶

A common issue that must be considered whenever an employer corporation makes contributions to an EPSP, is whether or not the contribution is subject to the reasonableness provisions of section 67 of the Act. The CRA has commented in numerous technical interpretations that their belief is that an employer contribution to an EPSP is subject to the reasonableness provisions of section 67.¹⁷ Many tax authors are of the view that contributions to an EPSP by an employer are also subject to a reasonableness test as outlined in section 67.¹⁸ However, in a technical interpretation released by the CRA in 1996,¹⁹ the CRA opined that it was willing to extend the administrative position applied to remuneration paid to owner-managers to EPSPs.²⁰ Subsequent technical interpretations released by the CRA and the Agency's revised administrative position outlined in Technical News No. 22, call into question the continued validity of the 1996 technical interpretation.²¹ A careful review of the criteria outlined by the CRA in Technical News No. 22 calls into question whether or not payments to an EPSP will be afforded the same administrative relaxation as that

offered for shareholder remuneration or other similar type payments.

Caution!

Allocations to Employee Beneficiaries

As outlined in the definition of an EPSP, the employee beneficiaries must be allocated, either contingently or absolutely, amounts no later than the end of the taxation year in which the contributions to the EPSP were made.²² To the extent that a beneficiary meets the definition of an employee,²³ the trustee will allocate amounts to the beneficiary using its discretion. Are amounts allocated by the trustee subject to the reasonableness provisions of section 67? Again, this issue has been the subject of debate over the years. However, a careful review of section 67 reveals a technical argument that section 67 should *not* apply to the allocation by the trustee to the employee beneficiaries. The reasoning behind the argument that section 67 should not apply to an allocation of amounts received by an EPSP to employee beneficiaries is that section 67 applies to deductions in respect of outlays or expenses. An allocation to beneficiaries of the trust by the trustee is not an outlay or expense. At face value, this would appear to open the door to income-splitting opportunities with other family employee beneficiaries of the EPSP. To the extent that the family employee beneficiaries of the EPSP are at lower marginal income tax rates than that of the principals, income tax savings could occur to the extent that amounts were allocated out to such lower income employee beneficiaries. Caution should be exercised in this type of planning.

Consideration should be given as to whether or not subsection 56(2) of the Act could apply to the extent that amounts were allocated to employee

beneficiaries by a taxpayer who is a trustee of the EPSP and perhaps is also an officer or director of the employer contributor corporation. Arguably, subsection 56(2) of the Act should not apply since subsection 56(2) only applies to a payment or transfer of property. It is the allocations from the EPSP that results in the tax liability to the employee beneficiary and not payments or property transfers out of an EPSP, thereby making it arguable as to whether or not subsection 56(2) would apply. In addition, one could speculate that to the extent that the CRA was offended by an allocation which resulted in obvious income splitting opportunities that the CRA may challenge the deductibility of the original contribution to the EPSP under section 67 of the Act.

Source Withholdings

Subsection 153(1) of the Act requires the timely withholding of income tax for certain amounts paid by payors. A review of subsection 153(1) reveals that amounts paid by an employer to an EPSP, and allocations made by an EPSP to employee beneficiaries, are not captured by the withholding requirements.²⁴

The requirement to withhold CPP is created under the CPP Act.²⁵ Under subsection 21(1) of the CPP Act, every employer paying remuneration to an employee employed by the employer in pensionable employment must deduct and remit the employee's CPP contribution for the year. The CRA has taken the position that allocations to a beneficiary from an EPSP are not subject to CPP withholding.²⁶

The obligation to withhold EI premiums is created in the EI Act.²⁷ Pursuant to subsection 82(1) of the EI Act, every employer paying remuneration to a person they employ in insurable employment must deduct

and remit the employee's EI premium. Using the CRA's logic,²⁸ there should be no EI withholdings on allocations to an employee from an EPSP, given that an allocation is not a "payment."

Hence, some practitioners design owner-manager remuneration so that the owner-manager is remunerated wholly through employer contributions to an EPSP so as to avoid withholding requirements such as income tax, CPP and EI. For plans designed to avoid CPP and EI withholdings entirely, all of the owner-manager's remuneration would have to be directed through an EPSP. This leads to an obvious question as to whether or not such a position would be challenged by the CRA. The CRA has opined in two recent technical interpretations that whether or not the payment of an employee's total remuneration through an EPSP is acceptable is a question of fact.²⁹ Accordingly, caution should be exercised in this type of planning.

Some practitioners have also suggested that an EPSP be established for the benefit of the sole shareholder of the owner-manager corporation. Although the EPSP definition does not exclude this possibility, the CRA has called into question the legitimacy of such an approach.³⁰ However, the definition of EPSP in subsection 144(1) reads "... for the benefit of employees ..." thereby indicating the plural and *not* the singular variable. Notwithstanding such plural language, subsection 33(2) of The Interpretation Act,³¹ states that words in the singular include the plural, and words in the plural include the singular. Accordingly, caution should also be exercised with this type of planning.

Income Tax Deferral Opportunities

Given the above framework, it should now be apparent that income tax deferral opportunities can arise with careful planning. The use of an EPSP can result in a greater deferral of taxes for the employee or owner-manager of a Canadian-controlled private corporation than would have otherwise been possible with the declaration of a bonus. As stated earlier, a bonus must be paid within 179 days after the end of the taxation year in which the expense was incurred (with applicable source deductions being paid shortly thereafter).³² An EPSP can potentially provide a tax deferral of one year beyond which would have been achieved through the accrual of a bonus. The deferral of federal and provincial income tax — along with the non-withholding of CPP and EI premiums — results in more funds in the employee's hands for a longer period of time, thus allowing greater investment returns on such retained funds.

Consider the situation of Mr. Apple and Opco. Opco wishes to obtain a deduction for its taxation year ending Dec. 31, 2004, and, accordingly, accrues a bonus at this year-end date. Opco will therefore obtain a deduction for the year ending Dec. 31, 2004, assuming that the bonus is paid within 179 days of the corporation's year-end. Accordingly, federal and provincial income taxes — in addition to CPP and possibly EI — will have to be remitted by the corporation on the accrued bonus within approximately six months of Dec. 31, 2004.

If, on the other hand, Opco makes a similar payment to an EPSP, the amount of money allocated to the respective employee(s) would be taxable in the 2005 calendar year (to

the extent that the payment was made to the EPSP in the 2005 calendar year and no later than 120 days after Dec. 31, 2004). But the taxes need only be remitted by the employee when the employee files his or her 2005 personal income tax return due by April 30, 2006 — a considerable deferral and advantage for the employee.³³ Accordingly, given the inherent flexibility and possible income-splitting opportunities with the use of an EPSP, consideration should be given to utilizing an EPSP in owner-manager remuneration planning.

However, caution should also be exercised given the above-noted comments throughout this section and also given the fact that EPSPs appear to have become a "tax product."

A review of the worldwide web by the author using the search term "employee profit-sharing plan" reveals numerous organizations that appear to "sell" EPSPs as products. As recent evidence of the CRA reviewing EPSP issues, one should review Technical Interpretation No. 2004-0062831I7- April 6, 2004. This technical interpretation is an internal memo between the Rulings Directorate and the CPP/EI Appeals Division Directorate. It appears that CPP/EI Appeals asked a question as to whether or not amounts contributed by an employer to an EPSP are always included in the beneficiaries' employment income when allocated under section 144 or whether there is a possibility that the CRA would recharacterize the nature of the employer's contributions when received by the employees as something other than employment income because of the type of income generated in the trust or in cases where the distributions were not made by the trust immediately after the allocation. The CRA responded

that for tax certainty to exist, the nature of the amounts for the purposes of determining the tax treatment must be determined at the time that the incidence of tax arises which is at the time of the allocation. Consequently, the CRA opined that they would not recharacterize the amounts for tax purposes. However, in a follow-up technical interpretation (2004-0062833I7-April 14, 2004) the CRA clarified that its comments in the April 6, 2004, technical interpretation only describe the mechanism of the EPSP provisions and that such opinion does not preclude the application of any other provision of the Act depending on the circumstance.

Consequently, careful planning should be done on a case-by-case basis to avoid the various tax risks associated with the use of an EPSP, but at the same time enjoy all the inherent opportunities that come with the use of such a vehicle.

In addition, certain non-tax issues should be considered by the practitioner when utilizing EPSPs as the desired form of remuneration for owner-managers. For example, consider the situation of a minority shareholder or "ordinary" employee. If a minority shareholder or "ordinary" employee had received most of his or her remuneration via allocations from an EPSP, a question could arise as to whether or not such a claim for wrongful dismissal would be compromised. Legal advice should be considered in such a situation. In addition, the use of an EPSP as the desired form of owner-manager remuneration may compromise or reduce the beneficiaries' abilities to receive benefits from CPP and EI into the future.

Endnotes

¹ An earlier version of this article appeared as part of a paper presented at the 2004 Canadian Tax Foundation's 56th Annual Conference entitled "Recent Issues in Owner-Manager Remuneration Planning".

² Unless otherwise indicated, all statutory references are to the *Income Tax Act*, RSC 1985, c.1 (5th Supp.), as amended and proposed to be amended, and including the regulations promulgated thereunder (the "Act"). Unless otherwise stated, statutory references in this article are to the Act. No assurance can be given that proposed amendments to the Act will be enacted in the form proposed or at all.

³ As defined in subsections 248(1) and 144(1).

⁴ See the definition of "employee" under subsection 248(1) of the Act.

⁵ IT-379R provides the CRA's views on this topic.

⁶ See Technical Interpretation No. 2001-0114625-February 22, 2002.

⁷ Technical Interpretation No. 2001-0067315-February 14, 2001.

⁸ See paragraph (b) of the definition of employees profit sharing plan under subsection 144(1) of the Act.

⁹ See subsection 144(3) and paragraph 6(1)(d) of the Act. It is important to understand that it is the *allocation* to the employee beneficiary that results in taxation and *not* the payment to the employee beneficiary from the EPSP.

¹⁰ An *inter-vivos* trust is defined under subsection 108(1) of the Act.

¹¹ An *inter-vivos* trust is taxed on its taxable income at the highest tax rates applicable to individuals pursuant to subsection 122(1) of the Act.

¹² 65 DTC 5297.

¹³ The prescribed manner for the election is outlined in Regulation 1500(3) of the Act.

¹⁴ The CRA outlines its administrative comments in IT-280R. Paragraph 6 of IT-280R states that the formula may be expressed in various ways and profits may be defined either as profits of the year or as undistributed profits of the year and previous years. Examples that the CRA provides for "out of profit" formulas are:

1. A percentage of members' salaries in wages (subject to a minimum of 1%);
2. An amount equal to members' contributions (subject to a minimum of 1% of each member's salaries or wages); and
3. A fixed dollar amount per member per year (subject to a minimum of \$100 per member).

Paragraph 7 of IT-280R also states that other formulas will receive consideration, but a formula must not result in merely a nominal employer contribution so that the plan becomes primarily a savings plan for employees.

¹⁵ As outlined in subsection 144(5) and paragraph 20(1)(w) of the Act.

¹⁶ As outlined in subsection 78(4) of the Act.

¹⁷ See, for example, Technical Interpretation No. 9313525-July 20, 1993, wherein it states that amounts

deductible by two or more employer participants pursuant to subsection 144(5) and paragraph 20(1)(w) of the Act would be governed by the reasonable test in section 67 of the Act.

¹⁸ See, for example, Evan Shoforost, CA, "Professional Incorporation", *2002 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2002), 9:1-50; Susan L. Leach, CA, "Remuneration Issues for Owner-Managed Businesses", *1999 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1999), 7:1-48; Neil S. Colquhoun, CA, "Executive Compensation Update", *2002 British Columbia Tax Conference* (Vancouver: Canadian Tax Foundation, 2002), 17:1-21; Leonard R. Vandenberg, CMA, "Year-End Tax-Planning Considerations for the Owner-Manager", Report on Proceedings of the Forty-Eighth Tax Conference, *1996 Tax Conference* (Toronto: Canadian Tax Foundation, 1997), 55:1-46.

¹⁹ See Technical Interpretation No. 9528435-March 7, 1996.

²⁰ In Technical Interpretation No. 9528435, the CRA stated that in applying section 67 to EPSP contributions, the Department would use the same criteria that it had applied with respect to the deductibility of bonuses and other remuneration paid to individual Canadian-resident owners of private corporations who are actively involved in the day-to-day operations of the active business carried on by the private corporations.

²¹ See, for example, Technical Interpretation No. 2000-0055055 and Technical Interpretation No. 2000-001711.

²² For a recent case involving allocations from an EPSP to an

employee beneficiary, see the case of *Fischer*, 2003 TCC 272 [Informal Procedure]. The case involved a situation where an employer contributed \$1,000 to an EPSP and allocated to the taxpayer employee pursuant to subsection 144(3) the \$1,000. However, the \$1,000 would not vest to the employee until two years later. The Court found that the \$1,000 was taxable to the employee notwithstanding such allocation did not immediately vest. See also *Aspinall*, 86 DTC 1281.

²³ *Supra*, footnote 4.

²⁴ See Technical Interpretation No. 2000-0036107-September 8, 2000, and paragraph 15 of IT-379R which confirms the CRA's views that no withholding requirements are needed on payments to EPSPs by an employer nor on the allocation by the EPSP to the employee beneficiary.

²⁵ RSC, 1985, c. C-8.

²⁶ See T4001 — Employers Guide — Payroll Deductions, 2003. Presumably, the CRA arrives at this conclusion because an allocation from an EPSP to an employee is not the same as a payment to an employee. This is the reason cited by the CRA as a basis for its position that subsection 153(1)

withholdings do not apply to allocations from an EPSP to an employee.

²⁷ S.C. 1996, C. 23 as amended.

²⁸ *Supra*, footnote 27.

²⁹ See Technical Interpretation No. 2000-0055055-December 4, 2000, and Technical Interpretation No. 2000-0017116-April 6, 2000.

³⁰ See, for example, Technical Interpretation No. 2000-0056145-January 9, 2001. The CRA opines that, generally, EPSPs are established for the benefit of several employees of the employer. They further state that they are not aware of any EPSPs that are established for the benefit of a single employee and that they have previously opined that an EPSP has to be established for the benefit of more than one employee.

³¹ RSC 1985 c.11 (1st Supp.)

³² Subsection 78(4) of the Act.

³³ Personal income tax installments for the 2006 calendar year would also be due by the employee in this example to the extent that he or she owed more than \$2,000 of income tax when he or she filed his or her 2005 personal income tax return — see subsection 156(1) of the Act.

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