

# R<sup>C</sup>F News

ISSUE 11

## *Leveraged RCAs – What is the Concern?*

*By Roy W. Craik*

### *What CRA Have Said:*

- It is a question of fact whether an RCA exists (Document #9726065, November 19, 1997)
- Would the arrangement be an RCA if funds were returned to the employer as a loan or investment (Document #97300767, December 11, 1997)
- We may question whether an RCA exists (Document #9807000, July 1998)

The above statements are from the Canada Revenue Agency (CRA) in response to queries as to Front End Leveraged Retirement Compensation Arrangements (RCAs). For more details, please refer R<sup>C</sup>FNews Issue #2 (“Loan-Back Retirement Compensation Arrangements with Employer Corporation by Carl Rosen, BA, B.LITT, LL.B., J.D) located in the R<sup>C</sup>FLibrary at [www.rcf.ca](http://www.rcf.ca)

### *Are Leveraged RCAs allowed?*

What CRA have not said is “Yes” or “No”. Why? One reason is that there are some circumstances where a Front-End Leveraged RCA might be acceptable. Perhaps they do not want, so to speak, to ‘throw the baby out with the bath water’.

For example, public corporations must show as liability on their financial statements all unfunded costs for supplemental pensions. As a result, many corporations not only want to eliminate this note, but deem it prudent to provide some security to their executives. In funding an RCA, part of the liability is for past service. On a cash flow basis, the corporation most likely would want to fund on a going forward basis, the annual contribution being a blend of past and future service. But this does not totally remove the note for the past service liability.

To not show this liability for past service would likely require a substantial initial contribution to the RCA, perhaps more than the corporation deems prudent relative to current cash flow. One solution would be to make the past service contribution, then borrow the money back and amortize the loan off over whatever years are required to fund the RCA. Providing the security to the RCA is adequate (Rated Commercial Paper, for example), there is a legitimate business reason for the transaction and the executive security has not been impaired by the transaction. CRA would not likely find it abusive. The corporation has a legitimate liability and is dealing at arms length with its executives.

Clearly though, CRA by their statements are concerned about the abusive use of RCAs for financing purposes. They now require the Trustee of an RCA to provide documentation of any loan arrangement when filing the annual RCA Trust return. **CRA not only know which RCAs are front-end leveraged but who the taxpayers are.** Considering this, financial advisors, lenders, and professionals involved in front-end leveraged RCAs should tread carefully.

### *Abusing the System*

What is happening in the US over abusive tax shelters designed by one of the big four accounting firms should cause proponents of some front-end leveraged RCAs to rethink what they are recommending.

So what is the concern? Quite simply – tax evasion (a criminal offence) not tax avoidance.

Most front-end leveraged RCAs are being established for connected persons of Canadian Controlled Private Corporations (CCPCs) that pay a high rate of tax on earnings over the small business limit.

Consider the 100% owner of a CCPC who makes \$1 million over the small business limit, but who needs or wants to reinvest all of the corporation's earnings back into the corporation. On the small business earnings, the rate of tax is approximately 20% (varies by province) but on the excess earnings the tax is close to 50% (if paid out as a bonus). A \$1 million contribution to the RCA saves the company approximately \$500,000 of tax. A loan back from the RCA of 90% of that contribution gives the corporation an extra \$400,000 of working capital. A tantalizing prospect that can lead to some easy sales, and substantial fees. Front-end leveraged RCAs are done either on a one time basis, or over a number of years. An actuarial certificate is obtained to support a large amount of past service funding.

## *The Concern Over Abuse*

Consider what could happen:

1. OpCo fails to pay the interest and/or principal to InvestCo on its loan
2. InvestCo has no other assets and cannot pay the RCA its interest and/or principal
3. The RCA defaults on its loan to its lender
4. The lender calls the loan. It first recovers the security in the RCA Investment Account (RCAIA) and then causes the Trustee to elect to get back (theoretically) the Refundable Tax Account (RTA) which it then recovers. If collapsed or terminated the RCA and number no longer exists.
5. The RCA then has no assets in the RCAIA nor in the RTA.
6. The Plan Member is out of luck. Does he sue the Trustee? Who is the Trustee? Does he sue InvestCo or OpCo? Or does he own both InvestCo and OpCo?

If the plan member controls both OpCo and InvestCo (directly or indirectly) is OpCo or plan member concerned about the money that OpCo owes InvestCo (that will never sue) that owes the money to the RCA (that will never sue) because the Plan Member will never sue the Trustee? Got it? **That no tax is ever paid is CRAs concern.**

## *CRA's position*

In the CRAs own words **"the function of an RCA is to secure certain obligations of an employer. If the purpose of a series of transactions does not satisfy this function it cannot be said that the arrangement is an RCA"**. If leverage is used in an RCA, it is important to therefore, not only ensure that the security to the loan is adequate but that the repayment terms are such that the RCA can provide the retirement benefits (at the

time required) to which the plan member is entitled. There should also be a valid business reason for the transaction. This is important enough in RCAs for employees at arms length but even more so for RCAs for connected persons.

Does a loan to OpCo only secured by the general credit of OpCo meet the legitimate security requirement of a plan member? Does the leveraged RCA meet the yield test? If the original RCA contribution is invested in a 'exempt' insurance contract with a fixed income yield of say 3%, does it make sense to pledge this asset for a loan at 6% if the mark up on the loan to the InvestCo and OpCo is only one-half a point each. The Trustees probably could match or increase that return by electing a different investment option in the tax "exempt" insurance contract without the loan risk.

## *Financial Advisor's position*

Financial Advisors that promote front-end leveraged RCAs better insure that the security to the RCA is iron-clad and that the documentation not only, properly protects the plan member, but that the corporation has a legitimate intent to establish a supplemental pension and is not using the RCA primarily as a financing vehicle. If CRA subsequently deems that the purpose of the transaction was not to provide retirement benefit, but to avoid taxes, the financial advisor, and tax professional maybe liable and subject to penalties. Even the lenders are vulnerable. Look what has happened to the banks over Enron.

## *Conclusion*

Although there is legitimate case for front-end leverage in some RCAs for accounting reasons and in others to increase the investment yield (if properly secured), if the sole purpose is for financing or with the thought that taxes may never be paid, think again. It may take a few years, but it could come back to haunt you.

**Roy W. Craik, President**  
Retirement Compensation Funding

R<sup>CF</sup> is the creator of the **PENSIONWrap™** (**RRSPWrap™** / **IPPWrap™** / **MPPPWrap™**) and **PENSIONPlus™**. RCA trust services are provided by BMO Trust Company.

This material is for information purposes only and should not be construed as legal or tax advice. Every effort has been made to ensure its accuracy, but errors and omissions are possible. Individual circumstances may vary and specific legal and tax advice is recommended. This material is based on current tax legislation and assessment practices and may be affected by future tax changes and market conditions.

**Retirement Compensation Funding Inc**  
416.364.6444 | info@rcf.ca | www.rcf.ca