RCF*News*

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RCA Abuses: CRA Speaks Out

Florence Marino, BA, LL.B, TEP, an AVP of Manulife's Tax and Estate Planing Group has red-flagged a CRA letter dated September 16, 2005 (2005-013240117) in a recent 'As a Matter of Tax' article released by Manulife entitled "CRA Reveals problems with RCA". (See RCF***Library***, articles section at **www.rcf.ca)**

This **internal** CRA Letter supports the conservative position that RCF has taken in the establishment of RCAs and clearly states what CRA considers abusive. Interestingly, the letter was in response to a question asked from an CRA assessment office on May 15, 2005 relative to the deducibility of employees' contributions to a Retirement Compensation Arrangement (RCA) under paragraph 8(1)(m.2.) of the *Income Tax Act*. CRA has used the response as a platform to address what they consider to be abusive in the use of RCAs in tax planning, and to instruct CRA employees what facts to consider when reviewing an RCA

CRA's Message

What should be of concern to proponents of some more esoteric RCA planning are some of the CRAs comments in this letter, and more specifically:

"it has recently come to our attention that innovative tax plans purporting to be RCAs are being marketed and promoted to allow both employers and employees to avoid tax and offer further benefits to employees over and above those offered to registered plans"

"For this reason, excessive contribution amounts and/or suspicious activities involving the use of an RCA, such as the scenario you've presented, should be flagged for further review"

Can CRA be any clearer in their intent to crackdown on what they consider abusive use of RCAs?

First Use of RCAs

The first use of RCAs was to fund the difference between the total pension promise by a corporation to an arms length executive over what could be provided by the corporation's Defined Benefit Pension Plan (DBPP). By way of example, many large public corporations promise their employees pensions of 2% per year of service x final 5 year average earnings. However, back in 1988, the maximum that a DBPP could pay out was $1,715 per year of service or $60,025 for 35 years of service. For a CEO with final average earnings of say $500,000, this presented a serious problem. A $350,000 promise vs. $60,025 of funding. Hence the use of RCAs to secure and fund the difference.

Salary Deferral Arrangements (SDA)

From the introduction of the RCA legislation CRA (then Revenue Canada) has always had the right to determine that a RCA is not an RCA but a SDA under subsection 248(1) of the *Income Tax Act*. As such, few RCAs were established for "connected persons" of private corporations until 1998 when Revenue Canada (in a round table discussion with CALU) relative to the use of RCAs for owners of private corporations said:

"a normal level of benefits would be the same benefit provided under a registered pension plan without regard to the Revenue Canada maximum. This would be 2% x years of service x final five-year average earnings or about 70% of pre-retirement income for an employee with 35 years of service".

Actuarial Certificate vs, Formula Based Calculations

In the funding of the RCAs for arms-length executives of a public corporation, RCF relied on certificates and projections from major actuarial firms. For owners of private corporations, RCF uses actuarial designed "formula based" software that clearly follows CRA guidelines. Most actuaries do not provide RCA ledgers or funding illustrations integrated with the Refundable Tax Account (RTA) with their certificates which make it more difficult to track whether the RCA remains onside relative to the CRA guidelines.

Some RCA providers try to suggest that an initial actuarial certificate is all that is needed in establishing an RCA. We at RCF think that is dangerous and that formula based actuarial software with revaluations every three years should be used. This is not to say that actuarial certificates should not be used. They are advised for large past service contributions relative to future earnings; for mortality adjusted group RCAs and in some cases for annual contributions in excess of $1 million for a single executive. However, the calculations and data used in the actuarial certificate should be capable of being converted into an RCA ledger that follows CRA formula guidelines.

It is therefore a myth that only actuarial certificates can be used in establishing an RCA. Formula based calculations such as RCF's entitlement and funding software (designed by Actuaries) are acceptable and specifically referred to in the CRA letter.

"Contributions amounts that are clearly supported by either an actuarial valuation or the use of some other formula based calculation may be more justifiable"

Concerns over entitlement calculation

The September 16, 2005 CRA Letter states:

"A sudden decline in the amount of remuneration paid to an employee suggests salary being rerouted through the particular plan to avoid tax and raises the question as to whether or not the plan is in fact a salary deferral arrangement and not a valid RCA"

RCF has always emphasized this concern particularly in RCAs established for connected persons. Even if working with an actuarial certificate, RCF has always insisted on an "Integrated Final Earnings" calculation based on future compensation and not on T4'd previous earnings. For connected persons, RCF has recommended that RRSP/IPP/MPPPs be included in the "Integrated Final Earnings" calculation for connected persons so that the total benefit from both the RCA and the RRSP/IPP/MPPP does not exceed the lesser of 70% or 2% x years of service fomula as indicated in the CRA guidelines. RCF also advises clients that the client's T4 slips in the years following the establishment of the RCA must be at least equal or greater than the initial compensation figure used in establishing the final entitlement and funding amounts. RCF recommends re-valuations every three years even though they are not mandated in the RCA legislation. To rely only on the initial actuarial certificate for the liability of the RCA (as some RCA providers would suggest), RCF believes is dangerous

Since bonuses are non-contractual, RCF has always had great concerns if they are included in RCA entitlement and funding calculations.

Reasonableness

In their letter, the CRA also state:

"As the Act is silent with respect to the determination of whether or not a contribution to an RCA is reasonable, it is always a question of fact and depends on the circumstances surrounding each plan".

In a RCA established in 2003 the "reasonableness" factor was the deciding factor in a client deciding to establish the RCA with RCF. Going back 5 years the clients T4 earnings were:

- 2003: $125,000
- 2002: $207,000
- 2001: $778,425
- 2000: $399,142
- 1999: $988,065

The 1999, 2000, and 2001 earnings were in years when the corporation had earned in excess of the small business limit and included bonus down to the small business limit and the 2003 earnings were base compensation. The client was 58 and wanted to retire in 10 years. In this case the client also received an "Actuarial Certificate" from another RCA provider.

In determining the entitlement and funding amounts, the actuary picked the best 3 year earnings with an average $721,881. Projected forward this resulted in a final RCA payout of $806,130 (no integration of RRSPs) and a current unfunded liability of $6,975,900. With future service, the actuary confirmed that the client corporation could contribute $10,187,300 to the RCA clearly, a staggering amount for an executive with a current T4 slip of only $125,000.

CRA have clearly stated that RCA entitlements are based on average final earnings not current average earnings.

RCF's conservative approach was to first use our formula driven software following CRAs guidelines to project forward the current $125,000 (indexed at 5%) integrated with the clients RRSP. The resulting RCA payout was $45,458. A substantial difference. The next step was to sit down with the client and accountant to determine what level of base salary was sustainable over the next 10 years indexed at 5%.

The RCA was established using a new base compensation level of $250,000 with appropriate source deductions for tax. The result was a total integrated pension of $215,416 with $62,250 from the RRSP and $153,166 from the RCA. Total corporate contributions to the RCA were $2,635,570 for an annual average of $263, 557 (blended past & future service).

In this case, the actuarial certificate produced much different results than the formula driven software following CRA guidelines. If the clients' corporation made a $6,975,900 lump sum contribution for past service for an owner with a current T4 slip of $125,000, would CRA challenge the deduction? Most likely.

For "connected persons" RCF factors in RRSP / IPP / MPPP benefits so that the combination of the income received from the RRSP and the RCA do not exceed 2% x years of service to a maximum 70% of final five year average earnings.

In certain circumstances we will use the final three year average, best three of last 5, or best 5 of the last 10 and for companies with cyclical earnings.

In the case discussed above, the "actuarial certificate" allowed a 72% payout from the RCA with no inclusion of the RRSP, even though the RCA was being established for a connected person. Clearly this is not what the CRA seems to have in mind.

RRSP Inclusion

In response to a question raised at the 2005 APFF CRA Roundtable, CRA said:

"CRA has recently studied the mechanisms or funds that are used to fund the benefits that employees can receive under non-registered or supplemental pension plans. CRA deems that these plans are generally RCAs when the mechanisms are pension plans and the benefits provided there under are reasonable. When a plan provides benefits that are not reasonable, CRA is of the opinion that it is a salary deferral arrangement".

In further discussion CRA indicated:

"benefits will not be deemed reasonable if, for example, they exceed those benefits that an employee could expect to receive based on his position, salary and the service rendered, or when they do not take into account benefits that were granted elsewhere under one or more registered plans."

For connected persons, RCF has always integrated all pension benefits including RRSP's so that when combined with the RCA, total benefits do not exceed 70% of final average earnings.

CRA on Loans

"Is the plan a valid RCA?" This question is specifically raised in the CRA response and they address their concerns. On the question of loans, they state:

"we would view a series of loans made from the particular plan back to the employer as potentially jeopardizing the validity of the plan as an RCA as the intentions of the plan become questionable."

This is not a new position from the CRA. In the past responses to queries as to Front-End Leveraged RCAs, CRA has stated:

- 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)

What should be troubling for the insurance industry is the July 1998 document since it was in response to a question put forward by CALU with the response distributed to CALU members.

It would be hoped that those recommending front-end leveraged RCAs are providing their clients with details of CRAs stated position. If they have not and the arrangements are attacked by the CRA, it would seem likely that not only those that promoted the arrangement will be held accountable but those that aided in the establishment will also be snared in the same net.

R^C F's position on loan back and front end leveraged RCAs is well known (See articles 'Loan-Back Retirement Compensation Arrangements with Employer Corporation' and 'Leveraged RCAs – What is the Concern?' located in the R^CF***library*** at **www.rcf.ca).** CRA is again confirming R^CF's position. R^CF listens to what CRA are saying and acts accordingly.

Employee Contribution

The CRA Letter of September 16, 2005 talks specifically to employee contributions relative to paragraph 8(1)(m.2) of the Act and should be understood by anyone considering such an arrangement. R^CF has examined some employer/employee contributions plans currently being marketed. They are clearly considered abusive by the CRA.

What might be acceptable? Many companies have Money Purchase Pension Plan (MPPP) that require a contribution of both the employer and the employee. If an RCA were established to cover employees hurt by the cap on MPPP contributions, it would be acceptable for the RCA to require employer and employee contributions in the same proportion providing the employee's contribution does not exceed 50%.

As the CRA states:

"Specifically, paragraph 8(1)(m.2) was intended to be a relieving position which would in part permit, within limits, the deduction of employee contributions where they are required under the terms of an unregistered pension plan that also meets the RCA definition. Consequently, before any amount will be deductible under paragraph 8(1)(m.2), the plan or arrangement has to be a pension plan."

If both the private corporation (with earnings of approximately $500,000 in excess of the small business limit) and the owner with personal taxable earnings of approximately $500,000 both borrow $500,000 to make a contribution to an RCA with the thought that they can borrow back $900,000 from the RCA to repay most of the bank loan and receive a deduction relieving both corporate and personal tax, they would be well advised to consider that CRA might have other thoughts on that matter.

Conclusion

Due to the these abuses pointed out by the CRA, we strongly recommend that clients only use RCAs for legitimate pension purposes. Most importantly the CRA guidelines should be followed and in questionable areas, particularly for connected persons, seeking an advance tax ruling is the most prudent decision one could make.

R^CF is the creator of the PENSION***Wrap***™ (RRSP***Wrap***™ / IPP***Wrap***™ / MPPP***Wrap***™) and PENSION***Plus***™. RCA trust services are provided by BMO Trust Company.

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