RCF News

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RCAs and Structured Investments

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RCA Entitlement

The Retirement Compensation Arrangement (RCA) provisions of the *Income Tax Act* allow the owner and/or key executive of a private corporation to supplement their pension up to what is referred to as the "generally accepted guidelines" which are 2% x Years of Service X final average earnings to a maximum of 70% integrated with the RRSP or corporate pension plan

By way of example, an owner (male 55) with 25 years of past service and earning $325,000 indexed at 5% to retirement would have a final five year average salary of $458,397, and a pension entitlement of 70% or $320,878.

For the purpose of this article, let us assume that the owner has moved from his RRSP (that had a current balance of $150,000) to an Individual Pension Plan (IPP) established by the corporation, enhancing basic pension benefits to $81,812. However, this still leaves a pension shortfall or gap of $239,066. This gap can be eliminated by an RCA that can be funded by the corporation at $356,680 annually.

RCA Funding

Even if the corporation makes the projected annual contribution to the RCA, investment performance is key in obtaining the desired results. RCF uses a 5.5% (net of MERs) rate in projecting the RCA funding cost. Since RCAs do not differentiate earnings between capital gains, dividends, and fixed income, RCF recommends that conventional investments be tax-sheltered using a PENSION***Plus***™ configured contract that can be obtained from most life insurance companies, and which allows the Investment Advisor a broad choice of investment options and recommendations to the client.

Yield

Although the goal is to generate the 70% pension combined with the RCA that might not be the result for three reasons:

1. The corporation does not make all the required contributions
2. Investment performance fell short
3. Final average earnings were higher than projected

What then can be done to enhance the supplemental pension from the RCA?

Often times, owners of a corporation have options other than traditional investments that can enhance the investment performance in the RCA either before or after retirement. CRA has expressed their concerns over loan-backs from a RCA to a corporation, particularly if the Plan Member is not dealing at arms length with the corporation and that financing seems to be the reason behind this the establishment of the RCA. Aside from this there are no other investment restrictions for RCAs. However the CRA has written of the importance of prudent investments for pension plans and RCAs so that standards of risk, appropriate yield, liquidity, etc. should be considered.

Yield Enhancement

Structured Investments are assets acquired by the RCA and related to the corporation's business which have significant growth potential or yield and can be acquired on a structured basis where the income more than covers expenses, or is acquired on a net, net basis (the seller pays the current expenses). Structured Investments should only be used in an RCA in addition to the PENSION***Plus***™ configured contract if it seems reasonable that the yield can be increased by 500 basis points.

Although, the underlying result can usually be found in land developers, heavy equipment users, and automotive dealerships, there are other loan-back arrangements that might be suitable. It is important however that all other assets in the RCA remain in a tax-sheltered pool.

Types of Structure

Let us look at three types of Structured Investments that likely would be acceptable to the CRA.

It is important to able to show that yield enhancement is needed to provide the required level of benefit. The structure should be established using normal business terms to prevent it from being viewed as a contribution to the RCA.

1. Land Developers usually do not receive the capital gain benefit on the purchase and sale of raw land whether this is done within the corporation or by the owner personally.
2. Heavy Equipment Users (Construction companies, road builders) most times turn to third party lenders or leasing companies for financing.
3. Automotive dealers frequently rent the dealer showroom owned by another company and require third party financing to finance new car inventory.

Establishing Structure

The advantage of the tax-sheltered pool of assets (using PENSION***Plus***™) in the RCA purchased with the net contributions by the corporation to the RCA is that they continue to grow on a compounded tax-free basis. As such, there is a larger pool of assets to be used for collateral purposes. Most insurance companies that can provide the PENSION***Plus***™ configuration and funding product for RCAs also have lending arrangements in place, although the clients own bank might want the business. It is also important that the tax-sheltered pool continue to be prudently invested to provide the highest yield. To do otherwise would negate the purpose of the Structured Investment, which is designed to increase the yield. Generally, it makes no sense to earn 3% on the collateral asset to pay 6% on the loan, even though, the collateral value of the tax-sheltered asset might be only 50%.

The asset purchased also has a collateral value, most likely in the 50% range. Meaning that 100% financing of the asset purchased is usually obtainable.

Asset Purchase

It is important that before any asset is purchased to complete the Structured Investment, proper legal and accounting advice be sought. For example, one would not want raw land as the underlying investment if it could be purchased in a manner that would result in capital gains.

It is also important that under the business structure that the RCA receives on the asset sufficient income or payments to cover all of its costs until the asset is sold (sometimes back to the corporation for development). The interest on the loan to the RCA should normally be deductible since it is used to purchase income producing property. As such, there is no requirement for a contribution to the Refundable Tax Account (RTA). When the asset is sold, ½ of the resulting profit goes to the RTA and the remainder is either dropped into the tax-sheltered pool (up to the exempt limit) or another Structured Investment is made.

Business Test

As has been mentioned, the purpose of a Structured Investment in the RCA is to increase the yield to provide benefits to the Plan Member and Survivor/Beneficiary.

For this reason, a business test should be applied to the investment to ascertain if the increased yield is, in fact, being produced.

- Raw Land: If raw land is the underlying investment (usually for those deemed to be professional), the time horizon should probably not exceed 5 years (unless for survivor benefits) and it would be wise to have documentation that clearly shows at least a 500 basis point yield advantage over the time frame that the raw land is held. There should be a development agreement requiring the payment of an annual fee to cover the trustee's carrying cost of the land, and interest on the loan, or alternatively there should be a net, net arrangement.

- Heavy Equipment: If heavy equipment loans are made, these should be structured to provide a yield of 500 basis points over the borrowing rate and secured in the same manner as a third party arms length lender. Lease-back arrangements where the CCA credit goes to the RCA are usually not suitable. Before the RCA considers equipment loans, it is important to ensure that the yield gain (after RTA Contribution) can flow back into the tax sheltered pool of assets under the PENSION***Plus***™ contract. As the tax shelter pool continues to grow, larger future equipment loans can be made.

- Rental Property: Since rental property is a long term asset, it is not usually purchased only using collateral financing in the RCA. Ideally it is purchased in part with top-up contributions to the RCA at retirement to fund the entitlement. Top-up contributions can be very substantial. Corporate assets could be sold if required to cover the cash flow requirement resulting in a carry forward loss to the corporation. These assets can then be purchased by the RCA and leased back to the corporation. For example, in a family owned corporation, a building could be owned by the corporation and used for corporate purposes. If an RCA has been set up for the father and the intent is to have children run the business after the father's retirement, it would be prudent to make any terminal funding payments prior to the father's retirement.

If there is not enough free cash flow in the corporation to meet the terminal funding obligation, the following transaction could be considered. As mentioned, it is always important to have proper legal and accounting advice.

1. The corporation borrows funds from the corporation's bankers to make the required terminal funding contribution the RCA. The corporation will receive a deduction for the contribution and carry forward the loss.

2. The RCA now has funds in the RCA investment account (half of the contribution has gone to the RTA).

3. The RCA uses these funds along with a loan (with the PENSION***Plus***™ tax sheltered contract as collateral) to buy a building or other assets from the corporation.

4. The corporation uses these funds to repay the bank. The corporation might also be subject to income taxes resulting from the sale of the asset which will reduce the loss to be carried forward resulting from the RCA contribution.

5. The RCA then enters into a rental or lease-back arrangement with the corporation, so that part of the income derived will be used to pay the interest on the RCA's loan and the balance of the income flows through to the Plan Member as supplemental retirement income to provide the additional 500 basis point yield.

6. Sometimes the bank will not require any principal payments on the loan (they have both the building and the PENSION***Plus***™ contract as security) or the amortization schedule is long enough that principal payments are minimal. Enough extra mortality can usually be left in the PENSION***Plus***™ contract to pay off the loan at the Plan Members death.

7. The surviving spouse and/ or children will receive benefits from the rental and/or lease-back income and from

the net proceeds of the PENSION***Plus***™ contract. Further tax sheltering may be obtained by buying another PENSION***Plus***™ contract on the beneficiary(ies) providing annual payments until the obligations of the RCA have been fulfilled. The 21 year rule does not apply to RCA Trusts. As a result, if Dad and Mom do not live to normal life expectancy, whatever remains in the RCA is a creditor protected pool of assets that can provide a stable flow of income to their beneficiaries until the RCA has been exhausted.

Conclusions

The primary purpose of an RCA is to provide a supplemental stream of income at retirement up to CRA guidelines. This can be obtained by fully funding the RCA on an annual basis as required and the utilization of tax-sheltered investments through PENSION***Plus***™ .

If the required stream of income cannot be met because of the reasons given earlier, a Structured Investment using the PENSION***Plus***™ contract as collateral may provide the additional investment yield required.

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