Manulife Financial

As a Matter of Tax

from Manulife's Tax & Estate Planning Group

CRA reveals problems with RCAs

Recent CRA commentary on the subject of retirement compensation arrangements (RCAs) suggests that the CRA has some problems with certain planning that involves RCAs.

The CRA's letter 2005-0132401I7, dated September 16, 2005, provides rather extensive commentary regarding "suspicious activities involving the use of an RCA" that should be "flagged for further review" and what the avenues of attack on these arrangements would be. Several of these are further highlighted in response to Question 12 at the APFF CRA Roundtable (dated October 14, 2005).

In the September letter, the CRA suggests that the analysis should focus first on whether the particular plan being considered is "a valid RCA". Plan documents would have to be examined and discussions held with both the employer and the employee to determine the "ultimate intentions" of the plan.

Plans that may not qualify as an RCA include a plan "entered into with the intention of paying or allowing for discretionary benefits to employees before a termination of employment, or where there has been no substantial change in services rendered by the employees." This confirms earlier comments on this point. (See *As a Matter of Tax* for October 2004 - "Plan with discretionary benefit payments before termination – RCA?")

In relation to another area, CRA further commented "we would view a series of loans made from the particular plan back to the employer (or loaned to a related entity in or outside of Canada) as potentially jeopardizing the validity of the plan as an RCA as the intentions of the plan become questionable."

The application of the salary deferral arrangement ("SDA") rules also must be ruled out. The SDA rules, in essence, trump the RCA rules. In particular, the CRA suggests that "the facts of any particular situation must support that none of the main purposes for the creation of the plan or existence of the right under the plans was to postpone tax payable…by either party."

(continued)

Florence Marino, B.A., LL.B., TEP
As AVP of Manulife's Tax & Estate Planning Group, Florence provides tax, estate and insurance planning support and consultation to advisors working in the affluent and business markets.

That is, in the CRA's view, tax payable relates to either the employee's tax or the *employer's* tax. The latter appears to be at odds with the wording of the Act (248(1) definition of SDA). To the CRA, an indicator of an SDA would be "a sudden decline in the amount of remuneration paid", as revealed by examining employment record and remuneration history.

In its APFF response, the CRA stated, "when a plan provides benefits that are not reasonable, CRA is of the opinion that it is a salary deferral arrangement." And that "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 services rendered, or when they do not take into account benefits that were granted elsewhere under one or more registered plans."

Intertwined with its discussion of an RCA's validity and the reasonableness of contributions was a discussion of the parameters for employee contributions to an RCA. In the September commentary, the CRA stated that before any amount will be deductible to the employee (under 8(1)(m.2) of the Act), the plan or arrangement has to be a pension plan. The CRA suggested the following questions be explored in determining this question:

- Is there any indication that the relationship that exists between the employee and the employer is, in fact, a non-arm's length relationship?
- In other words, does the employee have the power and control to determine all or any aspects of the plan, including funding amounts?
- Are there any other employees of the employer who are members of this particular unregistered plan? How do the benefits under the plan compare?

In determining the reasonableness of a contribution, the CRA noted that amounts supported by either an actuarial valuation or the use of some other formula-based calculation "may be more justifiable; however, reasonability must be weighed taking into account all the relevant factors."

As far as grounds of attack are concerned, the CRA summarized the following in its response to the APFF question:

> Tax avoidance strategies that are presented as RCAs will be especially targeted for examination, in order to apply, among other things, salary deferral arrangement rules, to refuse deductions, to apply section 15(1) or the general anti-avoidance provision.

A few scenarios were specifically mentioned as problematic: contributions of "exaggerated amounts for the benefit of shareholder officers who will subsequently receive these amounts after leaving the country." Also mentioned were "corporations…seeking to use these mechanisms in order to keep their profits uniform or deduct contributions that are part of a series of contributions or loans."

One can only conclude that the CRA will be examining RCAs more closely. Since the employer must apply for an RCA account number and submit a copy of the RCA trust agreement to the CRA when an RCA is established, it won't be difficult for the CRA to find RCAs to look at. Knowing this, what's the best protection? Independent professional advice.