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RCAs and Business Succession

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A Retirement Compensation Arrangement (RCA) can, not only be a key plan to any business owner in ensuring an adequate pension but, sometimes can form an integral part of the exit strategy from a business. However, to believe that the establishment of an RCA can avoid all tax and/or recaptured depreciation on the sale of a corporate asset is simplistic at best. Some such arrangements might be challenged by the CRA. Even though CRA eventually does receive tax on deferral strategies, their use is closely monitored and tied to fiscal policy. That is why there are limits on RRSP contributions

In an Income Tax Technical News #34 on 27/04/2006 (Please refer to RCF***News*** Issue #12 Special Update on RCA abuses located in the RCF***Library*** at **www.rcf.ca**) CRA has stated:

"Tax avoidance schemes purporting to be RCAs will be targeted for review with the aim of, for example, applying the salary deferral arrangement rules, denying deductibility, applying subsection 15(1), and/or subjecting the arrangements to GAAR."

It is important to clearly understand the definition of an RCA found in subsection 248(1) of the *Income Tax Act* which states, contributions are made by an employer or a former employer

- To a custodian.
- In conjunction with benefits that are to or may be received or enjoyed by any person.
- On after or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the tax payer or the loss of an office or employment of the taxpayer.

In a more recent Technical Interpretation #017117117 (29/03/2006) the CRA confirmed that the plan was not an RCA because the benefits paid under the plan were not reasonable in the circumstances and the contributions were not paid by the ACO as an employer to the custodian of the plan.

What is clearly important in establishing an RCA is that there first must be a clear employee/ employer relationship, there should be a clear intent to establish a supplemental pension, and benefits must be reasonable and should follow what are referred to as the "generally accepted guidelines" namely:

"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." (CRA Roundtable discussion, 1998)

Sale of Shares

Ideally, most business owners would like to sell the shares of their company. Not only is this the most efficient way from a tax perspective but the owner no longer has to worry about the corporation. However, sometimes the owner is not able to achieve the price that is desired for the shares. The buyer might not be able to afford and/or cannot arrange sufficient financing.

Sale of Assets

Sometimes a buyer does not want the corporation being concerned about pre-existing liabilities (tax and/or litigation) or for other business considerations.

A problem arises if the assets purchased have been depreciated or are not considered to be assets subject to capital gains.

Use of RCA

In both these situations, an RCA could be a solution providing the RCA has been established and is being funded in a manner acceptable to the CRA.

A seller might accept less for shares if a retiring allowance was offered which could be funded by the buyer with future pre-tax corporate earnings.

With the sale of assets, tax on all or a portion of taxable income might be mitigated by a contribution to an RCA particularly, if the RCA has already been established but, is not totally funded.

Shareholder/Employee

The *Income Tax Act* clearly states that there must be an employer/employee relationship to establish an RCA. That is why sole proprietors must incorporate to establish that relationship if they want to use an RCA. However, shareholders are not necessarily employees of their operating companies. They could have a HoldCo which owns the shares of the OpCo taking their income via dividends from OpCo to HoldCo. It is important not only that the employer/employee relationship be established if a RCA is contemplated in the future, but the earlier the better, to lock in the years of past service.

Intent

In non-arms length dealings, it is important that there is documentation that clearly shows the company's intent to establish a supplemental pension for the owner, funded and secured by an RCA and, preferably with funding to start in advance of any sale. If the RCA is established at the time of sale (particularly an asset sale), the CRA might challenge the intent.

Establishment

The goal of any business owner should be to at least have an adequate income at retirement, ideally a combination of pensions that will provide 70% of pre-retirement income indexed to inflation. This can be provided through a RRSP or RRSP/IPP combination with the shortfall made up by using an RCA. The sooner these plans are established the better. Both the RRSP and RCA allow for the carry forward of contributions. Certainly by age 55 a business owner should be reviewing all options if retirement and/or the sale of the business is contemplated at age 60 or 65.

Funded Example

Looking at a male owner age 55 currently earning $325,000 annually (indexed at 5%). His final 5 year average salary would be $458,397. At 55, he had an RRSP with a balance of $150,000 but moved to an RRSP/IPP combination that is projected to provide him a pension of $81,812. His desired pension (at 70% of final five year average earnings) is $320,878 leaving him a shortfall of $239,066.

Funding this shortfall is precisely how CRA intends RCAs to be used. In this case the annual funding requirement by the corporation to age 65 would be $356,680. If the corporation was in the position to make these contributions and earnings are as projected, the RCA would be fully funded at retirement. Hence no further contributions to the RCA could be made as a result of any sale transaction by the corporation.

Partial Funding

Oftentimes, the corporation does not wish nor has the resources to fully fund the RCA. That does not change the entitlement of the supplemental pension (providing the final five year average earnings support it). Other times, the RCA has been funded as originally projected but final earnings are significantly higher. Let us look at three examples

Example #1: The RCA was established but the company only funded $100,000 annually for 9 years. The result is that the supplemental pension would only be $67,025 annually (indexed at 2%) far short of the desired $239,066. To meet this objective would require a terminal funding contribution in the year before retirement of $3,008,897.

Example #2: The RCA has been established and funded as in Example 1 but the final average salary is $750,000 up from the $458,397. The required terminal funding contribution in the final year jumps to $6,480,225.

Example #3: The RCA has been established and funded as in Example 1 but the final average salary is $1,000,000. The required terminal funding contribution in the final year is $9,419,160.

Terminal and Post-Retirement Funding

Since the RCA was established prior to retirement with the clear intent of providing the owner (as an employee) with a supplemental pension, there should be no objection from the CRA that it be funded by the corporation when they are in a position to do so. The funding liability is as a result of the pension entitlement and the intent to provide the supplemental pension prior to any asset sale and/or new owner of the corporation. The funding could come from cash generated by the sale of assets and/or on a post retirement basis from pre-tax earnings guaranteed by the new owners of the corporation with the deductions to allowable limits.

If RCAs are terminally funded with funds coming from the sale of depreciated taxable assets a CRA audit should be anticipated. It is therefore important that RCA documentation, entitlement, and funding calculations all be in good order. A third party professional trustee at arms length is also recommended.

Conclusions

Unfunded RCAs for the owner of a corporation can be a useful tool in business succession. However, it is important that the corporation show a clear intent to establish the supplemental pension arrangement prior to retirement or any asset sale. CRA have the right to and have shown their resolve to challenge any RCA arrangements that they feel are primarily designed to avoid the payment of tax.

If business succession planning involves a contribution to an RCA from an asset sale and/or post-retirement contributions from a sale, of shares, we recommend that competent legal and tax advice be sought particularly, if the RCA is being established as part of the transaction. For existing RCAs properly established, a ruling should be requested if there is any concern over the size of the terminal or post-retirement contribution.

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