

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

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## ***Loan-Back Retirement Compensation Arrangements with Employer Corporation***

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Loan-back Retirement Compensation Arrangements (RCAs) have been increasing in popularity for a number of years. Some of these proposals involve a life insurance policy, which is purchased by the RCA Trust. Then the RCA Trust borrows the full value of the policy from a financial institution and lends the proceeds directly or indirectly back to the employer corporation.

The more aggressive of these scenarios also requires the RCA Trust to use the value of the Refundable Tax Account (RTA) as additional collateral, which would also be lent directly or indirectly back to the employer corporation. Under this scheme, 85% to 90% of the employer corporation's total contribution to the RCA and RTA is returned to the corporation. The financial institution generally requires guarantees from the employer corporation, the owner/executive and any other corporations which may be conduits or holders of the mortality portion of the policy.

On November 19, 1997, the Canadian Revenue Agency (CRA) considered an example where an employer would contribute \$2 million to an RCA with \$1 million remitted to the RTA (Document No. 9726065). The RCA would then borrow \$900,000 from a bank using the refundable tax as collateral and lend this plus the remaining funds (\$1million) held by the RCA back to the employer. The CRA stated, that "where funds are contributed by an employer to a custodian for the benefit of persons who are not dealing with the employer at arm's length, and the custodian lends the amount back to the employer", it is a question of fact whether an RCA exists.

In a technical interpretation dated December 11, 1997, the CRA considered the situation in which

an RCA Trust borrowed on the security of the funds contributed by the corporation and returned the proceeds of the loan back to the corporation, in the form of another loan (Document No. 9730067). The CRA questioned whether the arrangement would be an RCA if funds were returned to the employer as a loan or investment.

Reasoning that the payment to the RCA must be made in connection with the benefit to be received on retirement, the CRA again stated, "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. Where an employer makes a payment to a third party and the funds are effectively returned to the employer, either as a loan or investment in its shares, it is questionable whether the payment was made in connection with benefits to be received on retirement. If an arrangement is not an RCA, payments made by an employer under the terms of the arrangement cannot be deducted under paragraph 20(1)(r) of the Act."

The simultaneous establishment of an RCA with the lending back by the trustee to the employer corporation of either the proceeds of a loan or the assets of the trust itself suggests that the security of the retirement obligations by an employer is not the prime concern of the employer. If the RCA trustee also borrows from a financial institution additional amounts secured by the potential future refund of the RTA so that the employer corporation is borrowing back 85% to 90% of the total advanced for the RCA, the employer corporation's prime motivation would appear to be significantly increasing the

corporation's after tax cash flow for the corporation's purposes, and not securing retirement obligations to an employee. The employer corporation risks the denial of its deduction for the RCA contribution, plus interest and penalties, when the deduction is successfully denied on a reassessment following an audit.

In the 1998 CALU Report Vol. VII, No. 2, July 1998, Document 9807000, the CRA's position on Question 3, RCA Investments in employer corporation was, "The department's basic concern is what is the purpose of the series of transactions when the amounts paid to the RCA are returned in one form or another to the employer. We may question whether or not an RCA exists, as contributions under the arrangement may not be made in connection with benefits that are to be received by the taxpayer [the employee]. The issue is whether or not the purpose of the arrangement is to provide benefits to the employee after retirement, or whether there is some other purpose for the series of transactions." In Interpretation Letter # 2000-0050805 dated December 7, 2000, the CRA stated a "review of all the facts would enable us to determine the purpose of the particular arrangement in question particularly where several transactions form part of a series of transactions and the contributing employer recovers most if not all of its RCA contributions as part of that series of transactions."

A September 16, 2005 CRA Technical Interpretation was specifically sent to the Surrey Tax Services Office but provided specific rules for the tax office reviews of Retirement Compensation Arrangements. The CRA summarized the facts to be considered when reviewing a RCA to establish its validity and noted one of the questions to be determined "is there any evidence that funds held within are being loaned back to the employer or loaned to a related entity in or outside Canada." Thus, leveraging will bring a review of the RCA's validity. The CRA stated that "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."

Clearly, there is considerable indication from the CRA that a leveraged RCA risks the denial of the deduction for the contribution by the employer corporation as well as penalties and interest. The trustee may have difficulty receiving a refund of the RTA on the termination of the RCA.

There is no CRA interpretation supporting loan-back RCA structures to counter the three technical interpretations, and the CRA position in Question 3 of the 1998 CALU Tax Policy Roundtable. There is arguably a considerable risk for those taxpayers who chose to use the loan-back RCA structure.

In view of the firm position of the CRA on the dangers of a loan-back RCA, for those considering this structure, it is recommended that they should not risk using an accountant's opinion letter, but should obtain an advance tax ruling prior to undertaking the transaction.

Due to the uncertainty associated with leveraging assets within an RCA, we strongly recommend that clients seek independent tax and legal advice.

It also should be noted that the Trustees of the RCA are required to provide documentation of any loan arrangement when filling the annual T3/RCA tax return

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