

## Increasing The Amount Of Capital For Investment

### *Basic Concept*

A Company that has a substantial taxable income before bonuses typically has two alternatives as follows:

- Pay tax in the corporation and reinvest the after tax amount, or
- Pay bonuses to shareholder/managers or key executives

In the case of the first option an additional level of tax is paid when funds are ultimately distributed to shareholders. In the case of the second option the amount of the bonuses after tax can be

loaned back to the operating companies for corporate purposes.

In both situations the tax that is paid whether corporate or individual, is a permanent tax and in the absence of corporate losses is gone forever.

### *A Better Alternative*

An option that could provide more capital to invest and a better long term tax plan could involve the use of a Retirement Compensation Arrangement (RCA) coupled with the use of leverage.

### *Sample Transaction*

1. The Company makes a contribution to a trust for the benefit of a shareholder / manager or key executive. The example assumes a \$1,000,000 contribution of which \$500,000 is paid directly to the Canada Customs and Revenue Agency (CCRA) and \$500,000 is paid directly to the trust. The \$1,000,000 contribution is tax deductible to the company provided the amount is reasonable as discussed below.

2. The arrangement is treated as an RCA for tax purposes. This means that 50% of any contributions to the trust and 50% of any taxable income earned by the trust are paid to CCRA as refundable tax. The refundable tax is refunded to the trust as payments are made to the beneficiary of the trust.

3. The amount received by the trust directly is invested. There are no specific rules as to what qualifying investments of the trust might be. The cash value of a life insurance policy is often used to shelter the income of the RCA trust from ongoing payments of tax.

4. A financial institution lends up to 90% of the total of the refundable tax and the cash value of the life insurance policy.

5. The trust in turn lends the same amount back to the company that made the original contribution or to another entity.

*The net effect of the transaction is that more capital is available to reinvest. On retirement the beneficiary of the trust may be able to receive funds in a lower tax environment.*

### ***Are there any Contribution Limits***

An RCA trust typically involves a contribution for the purposes of providing retirement benefits or a termination payment to the beneficiary. For the plan to be taxed as an RCA and for the company making the contribution to have the contribution fully tax deductible, the payment has to be "reasonable" under the circumstances. A termination payment between arms length parties would be considered reasonable under most circumstances. Where the purpose of the payment to the RCA is to provide retirement benefits, an actuarial report would typically be obtained to determine the amount of a "reasonable" payment to the RCA. The actuarial report would consider such information as length of service, age, a projection of final average earnings, etc. The purpose of these calculations is to determine how much of a past service contribution could be made to the plan.

### ***Retirement Benefits***

The RCA trust is typically structured to provide retirement benefits at some point in the future. The structure can be much more flexible than a typical registered pension plan. One of the significant potential future benefits is that ultimately the taxation of benefits to beneficiaries will depend on where they are when they receive the benefits and what the tax rates are at that time. For example, if the beneficiary was a non resident at the time and the plan was wound up, both the invested portion and the refundable tax would be distributed to the beneficiary at a withholding tax rate (currently 25%).

### ***What are the financing arrangements***

Typically the lending institution will require the following:

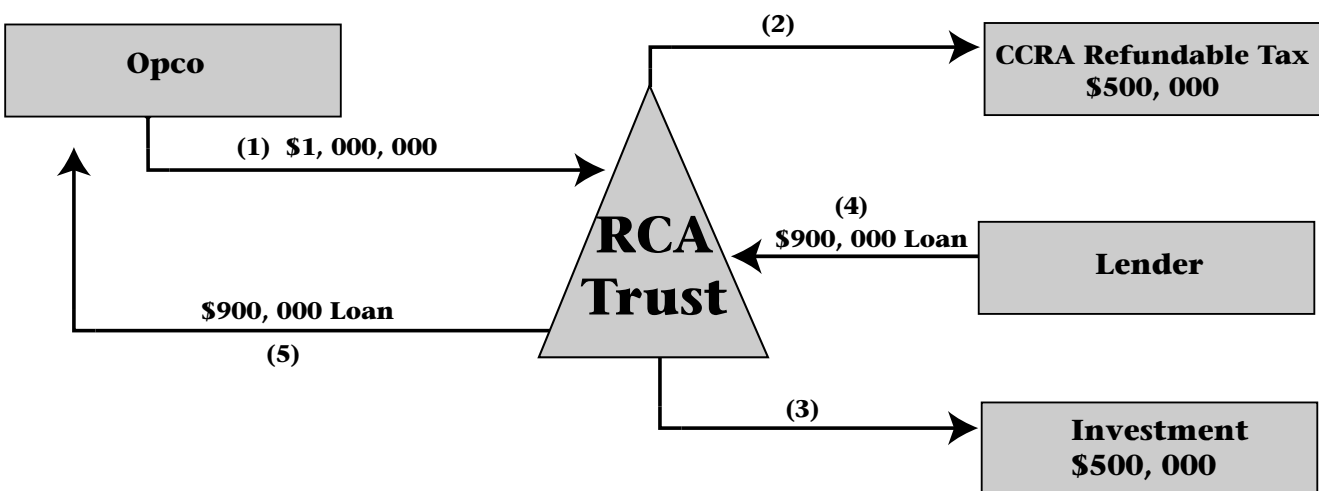
- General security agreement from the RCA trust
- Assignment of the note receivable by the trust from the company
- Assignment of the Universal Life policy or other investment
- Life insurance proceeds sufficient to repay the loan
- In some cases limited personal guarantees

Typically the loan needs to be paid off before retirement benefits commence. The length of time of interest only payment and ultimately the period of the loan amortization will depend on the lender and the financial strength of the company borrowing the money from the trust. Interest rates are typically very attractive.

***What investments are acceptable***

Although there are no income tax rules regarding qualifying investments, the types of investments are generally conservative, especially where leverage is involved. The cash value of a life insurance policy is often used as the underlying investment of the RCA trust so that annual payments of refundable tax will not be required. Using life insurance policies can also create planning opportunities in combination with other needs such as funding for capital gains tax, buy/sell agreements, and key man coverage.

**R.C.A. Leverage Loan Example**



***Is there a minimum?***

The leveraged RCA transaction involves costs and fees which make smaller transactions impractical. The practical minimum for leverage might be a contribution of \$1,000,000 and a loan of \$900,000. However, it is possible to make ongoing contributions to an RCA in lesser amounts and ultimately build up an equity and refundable tax which can be leveraged later on.

***Summary***

The RCA structure can provide for improved long range tax planning for shareholder/managers and executives. The combination of the RCA trust with leverage can allow additional funds to be available on attractive terms for business expansion, the retirement or buy out of another shareholder, equipment acquisition and other purposes.

The comments in this newsletter are intended to be general in nature. Specific situations should be reviewed by your accounting and legal advisors. If you have any questions or would like more information please contact your Zlotnik Lamb & Company advisor or the author.

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