WESTWARD ADVISORS

2012 FEDERAL BUDGET PROPOSES RCA RESTRICTIONS

THE ISSUE

On March 29, 2012, the Federal Budget announced new rules to prevent retirement compensation arrangements ("RCAs") from engaging in tax motivated transactions seeking unintended tax benefits.

An RCA will be subject to two new taxes as follows:

1. A tax of 50% of the fair market value of any **"prohibited investment"** acquired or held on or after March 29, 2012.
2. A tax of 100% of the fair market value of any **"advantage"** extended to or received by an RCA beneficiary or a person related to the RCA beneficiary on or after March 29, 2012.

Prohibited investments will generally include shares of, interests in, and debts of corporations, partnerships and trusts where the RCA beneficiary and persons related to the beneficiary collectively hold at least a 10% interest in the entity. Advantages generally include any benefit, loan or indebtedness involving the RCA that is not conducted on arm's length terms. The taxes may be refunded in certain limited circumstances.

An additional rule will prevent a refund of RCA refundable tax when the refund is attributed to an impairment in value of a prohibited investment.

WESTWARD'S POSITION

RCAs and Life Insurance

The new RCA taxes are not directed specifically at RCAs involving life insurance. However, RCAs often acquire a shared ownership interest with a related party in a single life insurance policy. The RCA typically owns the interest in the tax exempt cash value and a related party typically owns the interest in the policy's insurance protection. The purpose is to enable the RCA to invest its cash on a tax deferred basis inside the policy.

The Budget documents comment that some RCA *"arrangements use insurance products to allocate costs to the [RCA] arrangement for benefits that arise outside the arrangement."* Finance has noted that their particular concern is where the non-RCA owner of the insurance protection is not paying its fair share of the policy mortality costs such that the RCA-owner is paying for insurance protection benefiting someone other than the RCA.

Presumably such arrangements will now result in the application of the new advantage rules, causing an RCA tax of 100% of the value of the insurance charges paid by the RCA that the related party should have paid. Allocating insurance charges between shared owners is not always an easy task. Getting it right is now critical where an RCA is one of the shared owners.

Divesting Leveraged RCAs

Leveraged RCAs with life insurance are typically arranged as follows:

1. RCA invests 50% of an employer's contribution in the tax exempt cash value of a life insurance policy;
2. RCA obtains an arm's length loan secured by the policy cash value and the refundable tax account; and
3. RCA lends the loan proceeds to a related company.

The RCA's loan to the related party is now a prohibited investment and needs to be divested. This could cause a cash flow crisis in the company. The life insurance itself should not be a prohibited investment and need not be divested.

No Grandfathering

Unlike the new exemption test rules for life insurance policies, the new RCA taxes do not include any grandfathering provisions. To avoid the new taxes, existing RCAs have to (1) quickly divest prohibited investments, and (2) immediately avoid advantages.

Finance says the new rules target "a number of arrangements that seek to take advantage of various features of the RCA rules in order to obtain unintended tax benefits." Presumably, new legislation that shuts down arrangements where taxpayers are seeking unintended tax benefits does not qualify for grandfathering.

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