



Compliance Bulletin No. 5

For the past several years, the Registered Plans Directorate (RPD) has used its Compliance Bulletins to inform industry professionals about non-compliance issues relating to registered plans. In Compliance Bulletin No. 2 (2005), we alerted the deferred income plan industry about the increase in the number of questionable arrangements relating to both registered pension plans and registered retirement savings plans (RRSPs). Last year's Bulletin (No. 4) was entirely devoted to a detailed explanation of the RRSP strips issue. The focus of this year's Bulletin is to remind the registered pension plans industry to ensure that the primary purpose requirement of the *Income Tax Regulations* (ITR) is respected. It will also provide details of the possible consequences when the primary purpose requirement is not met. Finally the bulletin will present the salient details of the outcome of two recent court cases where the Federal Court of Appeal determined that the primary purpose had not been met.

Primary Purpose Requirement

To briefly summarize the policy surrounding the registration of pension plans, the RPD will register a plan only when its primary purpose is to provide lifetime retirement benefits to individuals in respect of service as employees with an employer who participates in the pension plan.

If, after an initial review of submitted documents for pension plan registration or an amendment to an existing registered pension plan, we believe that the primary purpose requirement may not be met, we will only register the pension plan or accept the amendment when the plan member/sponsor confirms in writing that:

- the pension plan was not established primarily for the purpose of receiving a transfer of benefits from the registered pension plan of a member's previous employer; and
- the pension plan was established primarily with the purpose of providing lifetime retirement benefits to individuals in respect of their service as employees with an employer who participates in the pension plan.

If it is subsequently determined that a registered pension plan does not respect the primary purpose requirement, we will advise the plan administrator of our intention to revoke the registration of the plan retroactively to its effective date.

Potential Tax Consequences

The following provides an overview of the potential tax consequences can be when the registration of a pension plan is revoked retroactively to its effective date.

1. When a transfer of pension benefits took place during a taxation year that is within the normal reassessment period (within three years from the date of the original *Notice of Assessment*, or of an original notification that no tax was payable for the year):

- the pension benefits transferred into the revoked pension plan are included in the plan member's taxable income for that year;
- interest is payable on the amount of taxes owed on that income; and
- a penalty is applicable if the individual's income tax return for the year in question was filed late.

2. When a transfer of pension benefits took place in a taxation year, which is not within the normal reassessment period (i.e., the tax return is considered statute-barred), and the amount was subsequently transferred to a RRSP:

- the transfer of pension benefits out of the revoked plan is considered to be a contribution to an RRSP at that time and not an eligible direct transfer under the *Income Tax Act* (ITA);
- a T1-OVP tax return must be filed and a 1 percent tax is payable for each month that an RRSP excess contribution exists;
- interest is payable on the amount of taxes owed;
- penalties are payable as a result of the late filing of this T1-OVP tax return; and
- any amounts withdrawn from the RRSP become taxable to the individual in the year of withdrawal.

3. When the CRA determines that a taxpayer misrepresented the facts of a tax matter involving the transfer of pension benefits, the resulting tax consequences would be as though the transfer occurred in a year that was within the normal reassessment period (see point #1 above).

Recent Federal Court of Appeal (FAC) decisions

The following summarizes the Federal Court of Appeal's recent decisions in two cases where it was determined that the primary purpose provision of the ITR had not been met. These cases can be reviewed in their entirety on the Federal Court of Appeal website by visiting the following links:

- [Federal Court of Appeal - Pension Plan For Presidents Of Jordan Financial Limited v. Canada \(National Revenue\)](#)
- [Federal Court of Appeal - Pension Plan for Presidents of 1346687 Ontario Inc. v. Canada \(National Revenue\)](#)

The details outlined below are taken from the reported decisions from the Federal Court of Appeal website.

Pension Plan for Presidents of Jordan Financial Limited

On December 28, 2000, ActuBen applied for registration of this pension plan on behalf of the employer, who was identified as both the plan sponsor and the plan administrator. With the documents that were filed upon the request for registration, an actuarial valuation report dated November 1, 2000, indicated that the employer had no history of earnings and that salaries were contingent upon receipt of future revenues. The documents also indicated that the expected annual earnings of the sole member of the plan were \$66,500. As part of the submission, the plan member included a statement saying he was an employee but not a shareholder of the corporation, and that the plan had not been established for the purpose of receiving transfers of funds from other pension plans. On March 28, 2001, the plan was registered with effect from November 1, 2000.

On March 28, 2001, the RPD began its repeated attempts to communicate with the plan member in order to raise the CRA's concerns about circumstances surrounding the establishment of the plan, as well as the potential consequences that could arise if the plan did not meet the ITA requirements. On September 5, 2001, \$754,513.47 was transferred into the newly registered pension plan from the member's prior public-sector employer's registered pension plan.

On February 4, 2003, the CRA began its audit of the plan. The audit revealed that during the period from 2000 to 2003, the plan member reported income from various other sources but had no employment earnings from the plan sponsor. In addition, no current service contributions had been made to the plan since its inception.

Pension Plan for Presidents of 1346687 Ontario Inc.

On October 6, 1999, ActuBen applied for registration of this pension plan on behalf of the employer, who was identified as both the plan sponsor and the plan administrator. The documents that were filed indicated that the employer was newly incorporated, with no history of earnings, and that its ability to pay salaries would be contingent upon receipt of revenues, the source of which was then unknown. Notwithstanding this statement, the documents indicated that the sole member of the plan anticipated receiving annual earnings from the employer of \$65,000. On November 15, 1999, the plan was registered with effect from August 1, 1999.

On March 21, 2000, ActuBen submitted an amendment to the plan that would permit the plan to credit the plan member with past service benefits. It also permitted the plan to receive a transfer of the commuted value of the pension entitlements under the member's former public sector employer's pension plan. On June 28, 2000, the RPD wrote to the plan administrator acknowledging receipt of the amendments to the plan, and clearly stated the CRA's concerns about the creation of individual pension plans for the purpose

of receiving transfers of the commuted value of previously accrued pension benefits. On January 20, 2000, \$564,478.56 was transferred into the registered pension plan.

On January 29, 2003, the CRA began its audit of the plan. The audit revealed that, during the period from 1999, to 2003, the plan member reported income from various other sources but had no employment earnings from the plan sponsor.

The Court's Decision

For each of the appeals, the Court stipulated that there was no basis for the appellant's contention that it did not know the nature of the CRA's concerns, and that it did not have an opportunity to respond to the concerns. The court confirmed that the CRA had complied with the rules of natural justice and procedural fairness in giving the Notice of Intent (to revoke), having regard to its dealings with the appellant and its representatives over the period since the plan was registered (five years in the case of Jordan Financial Inc. and six years in the other case). In conclusion, the court found that the appellants were unsuccessful in proving that the Minister was unreasonable to conclude that the primary purpose condition in paragraph 8502(a) of the *Income Tax Regulations* was not met. The appeals were dismissed with costs.

Conclusion

Extreme care must be taken when establishing an Individual Pension Plan, where there are concerns that meeting the primary purpose requirement of the ITR may be problematic. Generally speaking, a registered pension plan should not accept the transfer-in of the commuted value of benefits accrued under a former employer's registered pension plan until the pension plan sponsor (corporation) has firmly established an ongoing business income stream, which can then be paid to the plan member as employment income pursuant to a bona fide employer/employee relationship. In this way, the employee will protect the pension plan's valuable accruals from potential adverse tax consequences.

How to contact us

If you have any questions about these types of arrangements or have information regarding questionable arrangements, contact us at the Registered Plans Directorate. Our telephone enquiries service is available Monday to Friday from 8:00 a.m. to 5:00 p.m., Eastern Time (with a voice mailbox system to take messages outside those hours):

In the Ottawa area:

For service in English, call 613-954-0419

For service in French, call 613-954-0930

Toll free elsewhere in Canada:

For service in English, call 1-800-267-3100

For service in French, call 1-800-267-5565

We welcome feedback on this bulletin, as well as any comments related to compliance activities. Please send your comments by email to: rpdpdre@cra-arc.gc.ca.