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Four Tax and Valuation Concepts Made Easy

An Interesting Note About Farming and the Best Way to Hide Assets and Income I've Seen[1]

By Aaron Franks

1. The Retirement Compensation Arrangement/Account ("RCA")

An RCA is one of the best way to hide income and assets I have ever encountered. While it is certainly not an issue in every case,[2] unless one knows of its existence, it is impossible to detect.[3]

An RCA works something like this:

Suppose I am an executive, earning $800,000 a year. I can ask my employer to set up a Retirement Compensation Account with the Canada Revenue Agency (CRA). If my employer cooperates (and, as shown below, there is no reason for the employer to not cooperate), I can direct that my employer pay a given amount of my income to the RCA every year. For the purpose of this example, assume that I direct my employer to divert $300,000 a year to my RCA.

Despite the $300,000 diversion to the RCA, my employer still gets to deduct my entire $800,000 salary as a business expense – so my employer is wholly indifferent.

On my T4 for the year, on my income tax return, and on my Notice of Assessment, my income would be listed as **$500,000** (being $800,000 - $300,000), **not $800,000**. Furthermore, there is no reference to the income diversion *anywhere* on my income tax return or Notice of Assessment. I can do this each and every year – et voilà – I have successfully reduced my income by $300,000 a year, without a trace.

But it gets even better.

Of the $300,000 diverted each year, 50% ($150,000) goes to my Retirement Compensation Account, and 50% goes directly to CRA as, effectively, a prepayment of future taxes. The $150,000

[1] Aaron Franks of Epstein Cole LLP. No income or assets were intentionally hidden in the writing of this paper.
[2] An RCA will usually only be a potential issue in very high-income cases.
[3] For fans of the movie, *The Princess Bride*, an RCA is like iocane powder: "It is odourless, tasteless, dissolves instantly in liquid, and is among the more deadlier poisons known to man."

in my RCA Account is invested, and 50% of the income each year is transferred to CRA, again as a prepayment of future taxes.

If I did this for ten years, assuming 5% growth, at the end of that 10-year period, I would have an RCA Account worth approximately $1.9 million – and a prepaid tax account with CRA in the same amount. That is, I would have successfully hidden two assets worth about $1.9 million each – an RCA Account and a prepaid tax account.

In retirement, I am free to withdraw the $1.9 million from my RCA as I see fit. I will pay tax on my withdrawals at my tax rate in retirement, and the taxes will be paid from my prepaid tax account.[4]

But it gets even better.[5]

Should I ever decide to "leave" Canada,[6] I will pay a flat 25% withholding tax on my RCA, rather than pay tax at my top marginal rate (of about 46%), and any excess "prepaid tax" will be refunded to me. For this reason, this arrangement is very popular with highly-paid U.S. citizens that earn income in Canada, with plans to return to the United States – such as professional athletes.

In the end, look at what I have accomplished – all without a trace:

- I have reduced my income by $300,000 a year for support purposes;
- I have hidden assets totalling $3.8 million;[7] and
- I have the opportunity to save significant taxes if I leave Canada.

Sign me up.[8]

The moral of the story: if you represent a client with a spouse who is a high-income-earner and/or that has secondary citizenship, or if the spouse's income seems to have inexplicably reduced from historic levels – ask if the spouse has an RCA arrangement with his/her employer.

RCA's were briefly discussed in *Martin* v. *Martin*.[9]

2. <u>Deferred Income Taxes</u>

Deferred income taxes is one of those entries on business financial statements that many find confusing. But the concept is really quite simple.

[4] This is, actually, a bit of an over-simplification. When I wind up the CRA, I would withdraw the $1.9 million but will report the full $3.8 million. I would then owe about $1,763,200 in tax, and I would get credit for $1.9 million for a net refund of $136,800.
[5] This is starting to sound like an infomercial.
[6] By "leave" I mean quit the Canadian jurisdiction for tax purposes.
[7] Of course, there may also be up to $1,763,200 (46.4% of $3.8 million) in related liabilities.
[8] Can anyone lend me $300,000?
[9] (2004), 12 R.F.L. (6th) 415, aff'd (2006), 81 O.R. (3d) 495 (Ont. C.A.)

When an asset is purchased, accounting rules do not (usually) allow the asset to be "expensed" right away.[10] Rather, a portion of cost of the asset is written off each year over the useable life of the asset. We all know this as "depreciation."

There are many different methods of depreciation for accounting purposes,[11] but there is only one method of depreciation allowed by CRA for tax purposes. Counter-intuitively, CRA often allows assets to be depreciated more quickly than do the various accounting rules. For example, if a depreciable asset is purchased for $100,000, CRA may allow $25,000 to be written off in the first year, whereas generally accepted accounting rules may only allow $10,000 to be written off in the first year in the preparation of the corporate financial statements. This differential will result in the company depreciating the asset more quickly for tax purposes than for accounting purposes, and the result is that the company will actually pay less tax than the company "thinks" it owes. The resulting differential will be shown as a "deferred tax" liability on the corporate balance sheet.

For example, if the corporate accountants calculate that the company "should" pay $50,000 in tax in a given year based on accounting principles, but due to more generous depreciation allowed by CRA, the amount actually payable to CRA that year is only $30,000, the additional $20,000 would be shows on the corporate balance sheet at "deferred tax".

3. <u>"Recapture" of Depreciation</u>

Carrying on with the depreciation discussion, above, as an asset is depreciated over time, records are kept as to the "undepreciated balance" of the asset. For example, if an asset is purchased for $100,000, and depreciated by $10,000 a year for 6 years, at the end of the sixth year, the "undepreciated balance" would be $40,000 – the estimated amount of "useable asset" left. However, should the company then sell the asset for $60,000, the company would have to "recapture" into income the $60,000 - $40,000 = $20,000 in excessive depreciation it previously took on the asset. After all, if the asset sold for $60,000, the $40,000 undepreciated balance was an understatement of the remaining "useable asset" left at the end of the sixth year.

Therefore, "recapture" is really just the gain received from the sale of depreciable capital property that must be reported as income when the sale price exceeds the undepreciated balance of the asset. The difference between these figures is thus "recaptured" by being reported as income.

4. <u>EBITDA</u>

EBITDA is an acronym for "Earnings Before Interest, Taxes, Depreciation and Amortization."[12] It is sometimes thought to be a more "pure" measure of income from operations, removing the impact of corporate financing decisions, taxes and "non-cash" expenses like depreciation.

EBITDA is a far more useful finance concept than a family law or valuation concept. In fact, given that interest expenses, taxes, and depreciation impact the valuation of businesses, EBITDA is a

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[10] Sometimes, CRA will allow a certain assets class to be expenses immediately when it is looking to "incentivize" certain asset purchases.

[11] The easiest is "straight line depreciation": If the assets costs $100,000 and has an anticipated 10-year life, the asset depreciates (for accounting purposes) by $10,000 each year. That is the annual amount written off as an expense.

[12] Amortization is just like depreciation, but for intangible assets like goodwill.

relatively irrelevant concept for family lawyers. Now that you know what it is – you can safely forget it.

5. Games with Farms

Just to prove that I'm not Toronto-centric,[13] I have included this interesting and often-overlooked fact about farming income.[14]

Generally, businesses must account for revenue and expenses on an accrual basis: income is reported as it is earned; receivables are shown as assets when owed; expenses are reported as they are incurred; and inventory is expensed as it is used. Farms, however, may elect to operate on a ***cash*** basis. That is, for example, accounts receivable need not be shown as assets until actually collected; and inventory purchased at year end (say, December 27) can be immediately expensed (even if that inventory is returned on January 3).

Therefore, it is actually quite easy for a farmer to manipulate income.[15] The farmer can arrange for receivables to not be paid until the turn of the calendar. The farmer can also purchase a significant amount of inventory (grain, livestock, etc.) at the very end of the year, and then return it in the new year. If the farmer keeps increasing the end-of-year inventory purchases by the same amount every year ($100,000 in the first year; $200,000 in the second year; $300,000 in the third year, etc.), the farmer will effectively defer that amount of income in perpetuity.[16]

6. Redundant Assets

Valuation reports sometimes refer to "redundant assets." Redundant assets are assets that are surplus to the operating needs of the business – that is, they are ancillary to ongoing operations. Such assets might include art collections, investment portfolios, corporate jets, and excess cash or working capital.[17]

While most businesses are valued based on a capitalized maintainable earnings approach[18] (assuming they are going concerns) where a business has redundant assets, the value of those assets is *additional* to the capitalized earnings value for the business otherwise determined. Therefore, to value the business, any income attributable to redundant assets is removed from maintainable earnings and the (realizable) value of the redundant asset is then added to the capitalized value already determined.

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[13] Anyone that really knows me, knows that I'm just a displaced Vancouverite. Absent my wife, kids, friends, home and career, there is absolutely ***nothing*** for me here.
[14] And just to prove that I'm not land-centric, this also applies to fishermen and fishing income.
[15] Of course, I am not suggesting that farmers *do* manipulate their income. I only suggest they *can*.
[16] Anecdotally, there are some cattle and grain brokers that specifically "allow" this kind of thing to happen.
[17] The determination as to whether an asset is, in fact, redundant, is often a judgment call.
[18] That is, based on a consideration of how much someone might be willing to pay for the future anticipated earnings of the business.