PENSION*Wraps* and RCAs

Insurance and Advantage Rules

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The PENSION*Wrap*

Where a Retirement Compensation Arrangement (RCA) funded using life insurance or other investments described in Sec 248 (1) of the Income Tax Act, is wrapped around an RRSP, MPPP, IPP, PPP or DBPP to provide an owner/employee with a Supplemental Pension under prescribed limits including survivor benefits.

What is the concern?

By letter dated 14th December, 2015, the Canada Revenue Agency (CRA) responded to a submission dated 18th August, 2014 from the Conference for Advanced Life Underwriting (CALU) and an e.mail dated 11th December, 2015. This resulted from CALU wanting further clarification from a question raised at the CRA Roundtable session at the CLHIA Conference in May, 2013 and CRA's response (2013 – 0481421C6) where the CRA indicated in relation to why a Retirement Compensation Arrangement (RCA) would be holding a life insurance policy that provided for more than a nominal death benefit at the death of the insured.

"..the holding of such a life insurance policy by the RCA could give rise to an advantage in relation to the RCA and, therefore, advantage tax under section 207.62 of the Act"

In their 14th December, 2015 letter in relation to an example where an RCA is established for several key owner managers (specified beneficiaries) with benefits for insured members and other members over time paid from the cash value of the life insurance policies as well as from the death benefits of the policies with funds on the winding up of the RCA returned to the employer, the CRA expressed concern that this could be an advantage if the policy was acquired to provide key person coverage to indemnify the employer for potential loss of profits or additional costs incurred on the death of the insured a specified beneficiary. Clearly, the CRA concern was the potential abuse of the RCA by the group of owners if excessive death benefits were built in, and the CRA further said:

"In general, the determination as to whether an advantage in relation to an RCA arises, in a taxation year, because of a life insurance policy held in an RCA, and the determination of the amount of such advantage, are questions of fact"

Given the “advantage” rules it is important that a life insurance policy held by an RCA Investment Account (RCAIA) be properly structured.

Life insurance has been used in RCAs since 1988 as a secure method of providing Survivor Benefits and mitigating the loss of investment earnings in the RCA Refundable Tax Account (RTA).

If the contributions to an RCA allocated for Survivor Benefits were used to pay premiums, the mortality benefit paid to the RCA at the Primary death (when Survivor Benefits commence) would normally be higher than resulting funds if conventionally invested. It is hard to beat an insurance company on mortality benefits.

Questions of Fact

.Relative to a Retirement Compensation Arrangement (RCA), the facts are:

- The Primary Plan Member Entitlement is a percentage of final average earnings and years of service.
- The Survivor Benefit is a percentage of benefits paid at the time of the death of the Primary Plan Member

What is unknown is what these amounts are. So, what does CRA mean by “questions of fact”?

They are determined under the “Generally Accepted Guidelines” relative to Supplemental Pensions being secured and funded through an RCA.

To determine if there is an “advantage” from a life insurance policy being held as an asset of an RCA, i**t is both important that entitlement and funding calculations follow the rules and, that allocations to a life insurance policy be relevant to the results.**

Generally Accepted Guidelines

Entitlement Calculations

Contributions to an RCA should not exceed what is required to fund the entitlement under the Generally Accepted Guidelines for pensions which are:.

.“ a normal level of benefits would be the same benefit provided under a registered pension plan without regard to the Revenue Canada maximum. This would be 2% x years of service x final five-year average earnings or about 70% of pre-retirement income for an employee with 35 years of service." (CRA Roundtable discussion, 1998).

Failure to follow the generally accepted guidelines increases the risk that CRA could deem the RCA not to be an RCA, but rather a Salary Deferral Arrangement (SDA) with substantial tax and penalties payable.

To ensure the RCA qualifies under CRA's Generally Accepted Guidelines, an Integrated Final Earnings (IFE) calculation, determines entitlement from the RCA and the resulting maximum level of funding.

This entitlement calculation must be reviewed and recalculated periodically as circumstances change. Salary, bonus, registered pension (ie: RRSP) and RCA investment performance may vary considerably by retirement from the initial assumptions used.

Funding

Just as with Pension Plans, RCAs should not be overfunded (also over the concern that CRA might deem them to be a Salary Deferral Arrangement) nor, should they be underfunded and unable to provide the required benefits to both Primary and Survivor Beneficiaries.

The RCA Refundable Tax Account (RTA) earns no interest, mortality can vary widely and, the vagaries of investment earnings all effect required funding.

Oftentimes, owners of companies that establish a **PENSION*Wrap*** secured and funded by an RCA have concern over the provision of survivor benefits, that they will be paid and not exposed to investment losses.

Insurance Funding

The use of life insurance and annuities as assets can mitigate some of this concern but, provide an illustrative challenge relative to CRA and any advantage provided. **What cannot happen is for the funding cost of an insurance product, if used, be higher than if funded with Conventional Investments.** As well there should not be high remainder assets at normal mortality relative to normal funding and, benefits paid.

What is Acceptable to CRA

CRA in their 14th December, 2015 letter to CALU in relation to a specified beneficiary (but applicable to a non-specified beneficiary say (in part):-

"..and the amount payable under the life insurance policy on the death of the insured does not exceed the amount reasonably required to satisfy the survivor benefits payable in respect of the insured, then generally there would not be an RCA advantage."

Reasonable vs Exact

If a Survivor Benefit is known and is payable (the primary member has died), it would be possible to pay an amount from the RCA, so that, after personal tax, the Survivor could buy a Prescribed Annuity that would provide the same net benefit as if the Survivor Benefit had been paid directly from the RCA.

The cost to the RCA would be exact. If part of the payment came from the proceeds of a life insurance policy on the Primary member and, no funds remained in the RCA after the payment (s) to the Survivor, there could be no advantage.

That said, what is not known when the RCA is established is:- (i) when the Primary Member will die and, (ii) what the survivor benefit will be at that time. If the intent is to use life insurance to secure the Survivor Benefit, the challenge then is to determine what death benefit "reasonably" will secure the survivor benefit so as not to trigger an "advantage".

Insurance Fund Values

It is important that at retirement, cash values in contracts be equal or greater than projected values if conventional funding had been used.

RCA VALUES RCA Investment & Refundable Tax Accounts					
	Account Values				
Year	Conventional Funded RCA	Insurance Funded RCA	Insurance Cash Surrender Value	Difference between Conventional Account Value	Additional Death Benefit For Survivor
1	146,717	144,856	122,841	(23,876)	2,958,038
2	297,468	293,854	249,825	(47,644)	3,096,749
3	452,365	447,330	398,897	(53,469)	3,243,749
4	611,522	605,542	552,706	(58,816)	3,399,522
5	775,056	770,688	709,046	(66,010)	3,568,134
6	943,087	944,086	891,250	(51,837)	3,854,393
7	1,115,739	1,124,181	1,080,152	(35,587)	4,158,621
8	1,293,138	1,311,318	1,276,094	(17,044)	4,433,441
9	1,475,416	1,505,933	1,479,515	4,099	4,691,278
10	1,662,707	1,708,865	1,708,865	46,158	5,034,428
11	1,855,148	1,920,448	1,920,448	65,300	5,230,323
12	2,052,882	2,141,765	2,141,765	88,884	5,436,764

Insurance Face Values

The initial face amount or death benefit of an insurance contract is determined by the insurer relative to the contribution to keep the policy exempt from accrual taxation as per formulas set forth by CRA and stored in the insurer's computers.

Most insurers have a setting in their illustration software that allows the face amount to reduce following what is referred to as "the exempt curve" to the benefit ultimately required at the death of the Primary Beneficiary.

This is important in RCAs. It mitigates premiums impacting asset values required for Primary Benefits and, safeguards against the death benefit on a Primary Member (at normal mortality) being far in excess of what is required to provide Survivor Benefits so that properly used the RCA can provide key-person benefits which will not attract the ire of CRA for connected members.

Insurance Products

Not all insurance products work the same in RCA funding. Product selection and configuration can vary relative to ages, years to retirement and, required variability in funding.

With **Term to 100** or **Universal Life**, it is possible to set the face amount to the amount projected to fund the Survivor Benefits at death of Primary Member.

That is not the case with **Participating Whole Life**. By design, the initial Face Amount increases over time with Paid Up Additions. If Par is being used, care must be taken to start with a lower Face Amount so as not to create an advantage with excess funding.

If the **Primary Beneficiary is insurable**, both the assets in the RCA Investment Account and the Refundable Tax Account can be exhausted by the death of the Primary Beneficiary. The guaranteed death benefit pays Survivor Benefits eliminating investment risk for these benefits.

If the **Primary Beneficiary is uninsurable** and, the policy is issued on a **Joint and Last Survivor** basis, care must be taken that at the death of the last survivor (at normal projected mortality) there is not an excessive remainder death benefit with no plan members. This is more of a concern for Individual RCAs.

RCA Ledgers

These would not be provided in a normal conventional funded RCA by most actuaries but, can be of value if insurance funding is used. With a Conventional Funding Ledger as a comparison base for CRA if required, it is much easier to show that benefits from the use of insurance are not providing an "advantage". A Conventional Funded RCA can be split to show Primary and Survivor benefits and compared to the Insurance Funded RCA Ledgers.

Penalties

Prohibited Investments Tax

50% tax on the FMV of **Prohibited Investments** acquired or held by the plan at any time in a calendar year. This tax may be refundable if the Prohibited Investment is disposed of by the plan, generally within one year from the end of the year in which this tax arose.

Advantage Tax

Under the Advantage Rules, there is a **100% tax** on any **Advantage** obtained by the Relevant Person (or any non-arm's length person).

Summary

Life Insurance if used as originally intended remains an important asset for many RCAs. Unfortunately, some were misused and, the CRA has now clearly outlined the penalties for this. What is important is that RCA life insurance policies are properly configured and illustrated so that there is no concern over misuse.

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