Compensation

Using An RCA Provides 100 Per Cent Tax Deduction

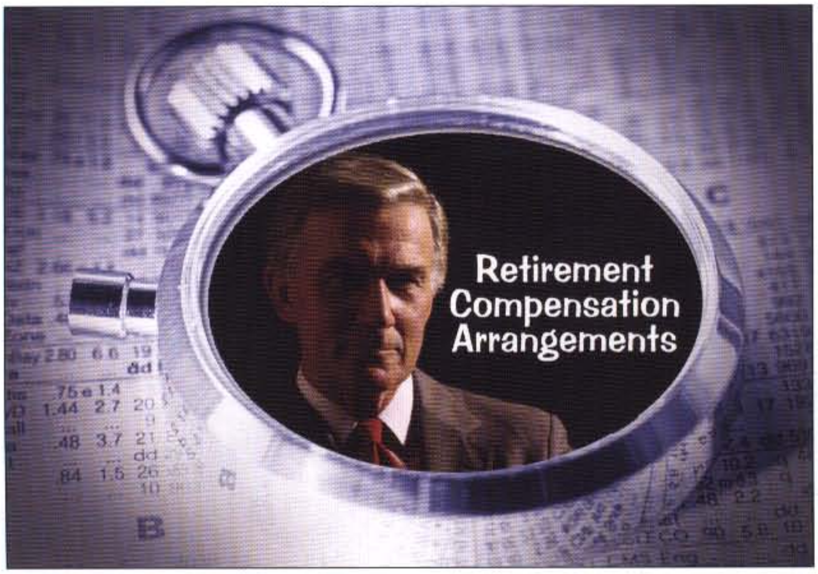
The New Executive SERP:

Tax Sheltered RCAs

By: Roy W. Craik

Roy W. Craik, of Retirement Compensation Funding Inc., examines how Retirement Compensation Arrangements can off-set the 'pension gap' for executives at private companies.

Retirement Compensation Arrangements (RCAs) (defined under Subsection 248(1) of the *Income Tax Act*) were originally used by public corporations (usually with a powerful key executive) to fund the difference between the pension promise and what could be provided by the corporation's pension plan. The focus was on the 'security' of the benefit since RCAs were not felt to be tax-effective for corporations with low tax rates and high Internal Rates of Return. Most large corporations preferred to cover the 'pension gap' for their top executives from post-retirement cash flow.



Canadian Controlled Private Corporations (CCPCs) started to use RCAs following guidelines established in 1998. Previously, there had been concerns that an RCA established for the owner of a CCPC could be deemed by CRA to be a Salary Deferral Arrangement (SDA). RCAs are attractive to CCPCs since they pay a high rate of tax over the small business limit when funds are withdrawn from the corporation. RCAs can eliminate 'pension discrimination' and put owners/executives of private corporations on an even footing with their colleagues in public corporations and, for public corporations, fund 'the pension gap.'

Current Realities

Many executives are starting to view their total compensation package differently than they did in the past:

- ◆ Changing demographics have more executives reaching the age when they are focusing on retirement leading to great concern that the realities of pension promises fall far short of what is funded.
- ◆ The requirement to expense Stock Option Plans, their frequent ineffectiveness in retirement planning and the perception by many that executive compensation is excessive, have led to the re-focusing on Supplemental Executive Retirement Plans (SERPs).

Using an RCA to fund the benefits provides the corporation with a 100 per cent tax deduction with no tax to the executive until benefits commence. The design of new funding products substantially improves the investment performance of the RCA and eliminates the ineffectiveness of the Refundable Tax Account (RTA).

Compensation Package

Due to contribution or benefit caps, high earners clearly suffer 'pension discrimination' under registered pensions. The advantage of the RCA is that there is no contribution cap, providing benefits do not exceed the 'generally accepted guidelines.' However, given that two per cent multiplied by years of service and final average earnings (integrated with corporate pension plans) have become the most common formula in Canada, the cost of funding can become a significant benefit to an executive and a meaningful component of an overall compensation package.

The value of the SERP component is often over-looked relative to bonus arrangements and stock option plans. As well, since they are based on income tax regulations, a SERP tied to 'generally accepted guidelines' can be easier to sell to shareholders and owners.

Value Of Benefits

The compensation component important to an executive varies, depending on their age, position in the company, and lifestyle requirements. As executives become older, earn more money and family commitments lessen, they tend to focus on the SERP component of a total compensation package if it is made available. In fact, even younger aged executives are starting to look longer into the future.

A funded SERP can provide an executive with a substantial additional income benefit at retirement that is meaningful to any executive when compared to what gains are required in a stock option plan to provide the same benefit.

SERP Vs. Stock Option Cost

When a SERP is established for an executive, the cost to the corporation and the benefits to the executive are clearly understood. Not so with a stock option plan. The value to the executive is uncertain, but the expenses to the corporation and shareholder are significant, yet subject to interpretation given that the accounting profession and securities regulators have yet to establish clear guidelines.

Because of the value of a SERP benefit to an executive, it is not unreasonable for the corporation to set profit targets for funding. This is both fair to the executive and shareholders who profit from the executive's efforts.

Stock option plans can often be a counter-incentive. Executives might make the funding targets, but if a corporation is one cent short of 'the street' expectations, where does that leave the executive?

The present controversy over back-dating stock option grants suggests that they have been utilized to take more immediate profits as a bonus and not for long-term compensation and retirement benefits. As well, 'spring loading,' where options are granted before a release of information that could sharply increase the value of the stock providing the executive with an instant gain, suggests the same motive. If these tactics are challenged, the effect likely will be downward pressure on the stock thus defeating the long-term purpose of the options unless gains are realized in the short-term.

Security Of RCA SERP Vs. Stock Option Gain

A SERP funded and secured by an RCA clearly shows the executive the value of the benefit if revenue and profit targets are met. This is not the case with stock option plans. What price will the stock be at retirement relative to the option cost? In today's market, there are many examples of well-known and successful companies with substantially depressed stock prices that are cash rich. Retiring executives from such companies would suffer and the stock option plan would be viewed as a counter-incentive by other executives.

Many companies have SERP agreements in place for executives that are unfunded. These can be as simple as a letter promising that the company will pay, out of post-retirement cash flow, the difference between the pension that has been promised and what is funded by the company pension plan. Given the publicity today to underfunded registered pension plans, it is no wonder that executives with unfunded supplemental pension plans are worried.

Considering that the *Income Tax Act* allows for funding under the RCA provisions, why then is the security of executive retirement being left at risk? In some cases, the executive's themselves are the reason for unfunded SERPs. They feel it would be hard for compensation committees to sanction a funded SERP and, at the same time, provide a stock option plan. If the SERP was funded, performance of the stock option plan might also be affected.

When SERPs are secured using a tax-sheltered insurance funded RCA, not only does the RCA provide the required retirement benefits to the executive, but it also cover's pre- and post-retirement death benefits. Over time, these death benefits compensate for the loss of earnings on the RCA Refundable Tax Account (RTA). They can substantially lower the corporation's long-term cost of funding the SERP benefits as compared to post-retirement 'pay as you go,' while, at the same time, providing the security of the RCA and third-party trustee.

Underwriting

Although RCAs funded through 'exempt' insurance products offer advantages as outlined, medicals are required for the mortality component of the policy and not all executives are healthy enough to satisfy the insurance company's requirements. This can be resolved through stacking, life substitution, and using joint contracts. Limited and guaranteed issue plans can be obtained for large groups. The sophistication of Canadian insurers has evolved dramatically in the past few years. They are on a par now with their colleagues south of the border in understanding the requirements of the retirement markets for funding SERPs.

Since survivor benefits are a result of someone dying, the use of mortality to fund them can either mitigate the corporate cost of providing them or result in an unreduced primary with a full two-thirds survivor benefit.

HR executives facing the challenge of finding more effective incentive models for senior executives should look at the effectiveness of tax sheltered RCAs. Companies with unfunded SERPs should also examine a tax-sheltered funded Group RCA. ■

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