Dealing with the Pension Shortfall

Retirement Compensation Arrangements vs. Corporate Insured Programs

BY CARL ROSEN

Despite increased salaries and performance bonuses, many business owners and executives find that the pension amounts available at retirement fall far short of the 70% of their best (or last five-year average) remuneration — a standard which most actuaries and pension specialists suggest as being necessary to continue an executive's standard of living. The difference between the pension provided by an RRSP (or pension plan) and the 70% pension goal is referred to as the pension shortfall.

ONE SOLUTION: THE RCA

One method of dealing with the pension shortfall was established by the federal government as a required method by corporations to fund pension shortfalls. Known as a Retirement Compensation Arrangement (RCA), set forth in section 248(1) of the Income Tax Act, RCAs are plans whereby an employer makes contributions of funds for an employee to a custodian or trustee to be distributed on the employee's retirement, loss of employment, or substantial change in the services provided by the employee. The RCA functions like a pension plan except that half of the contributed funds and half of the earnings are held by the CRA in a separate account earning no interest called a Refundable Tax Account (RTA).

Among the advantages of a properly established RCA is the creation of a separate fund safe from creditors providing long-term tax deferral. The contributions are tax deductible to the corporation and not taxed to the executive until received in retirement. If an exempt insurance policy is the asset of the RCA, the investment earnings are sheltered and there are no contributions of income to the RTA. The life insurance also provides completion of the pension in the event of demise before retirement, and the use of special software allows mortality costs to be adjusted and held to a minimum so that the insurance costs do not impair the performance as compared to a pool of investment assets in the RCA.

SECOND OPTION: THE CORPORATE IRP

Another method of addressing the pension shortfall is the Corporate Insured Retirement Program (CIRP), the purchase by the corporation, with after-tax dollars, of a universal life insurance policy with premiums sufficient to pay the required retirement benefits, and a death benefit, received tax-free by the corporation, allowing for the payment of tax-free capital dividends. The normal method of providing the funds is to have the corporation borrow against the policy (leveraging the policy); these funds are then paid to the owner/employee as a taxable benefit or are paid as dividends to the owner/employee and taxed as such. Since banks do not loan 100% of cash surrender values, funding for the policy must allow for policy values considerably in excess of the anticipated retirement funding. Further, the availability of the loans at retirement can impact the leveraging strategy. Of course, the company can borrow the funds for the retirement benefit from the insurance policy, but that would constitute a distribution from the policy which would be taxable in whole or in part as income to the company, depending on the adjusted cost basis of the policy.

CRA'S POINT OF VIEW

In establishing the RCA rules, the CRA recognized that corporations might seek to use insurance policies like the CIRP strategy to fund retirement benefits for owner/executives, and avoid the RCA requirements. Therefore, the RCA provisions include section 207.6(2) of the *Income Tax Act*, which provides that:

"where an employer is obligated to provide retirement benefits that are to be enjoyed by any person after retirement of a taxpayer and where the employer acquires an interest in a life insurance policy that may reasonably be considered to be acquired to fund in whole or in part those benefits, the person that acquired the interest is deemed to be a custodian of an RCA; the interest is deemed to be the subject property of the RCA; and an amount equal to twice the premium is deemed to be a contribution to the RCA; and any payment received in respect of the interest is deemed an amount received out of the RCA."

If the policy is deemed to be an RCA, then any death benefit which the corporation receives on the policy would be a distribution from the RCA, would be taxable, and would not be received tax-free.

Marketers of CIRP say that the key man aspect of the CIRP should be emphasized and that illustrations of retirement payments should "disappear." However, the actual record of borrowings and retirement payments will create an evidentiary background of interest to the tax auditors. The CRA is aware of CIRPs, some of which are now of sufficient duration for retirement borrowings to commence. It is to be expected that the CRA will encourage actions, by its tax auditors or by changed legislation, to ensure that section 207.6(2) is not evaded.

IN THE END

The purpose of the CIRP in providing key man insurance with the tax-free death benefit allowing tax-free capital dividends would be prevented if the policy were found to be a deemed RCA under 207.6(2), due to the provisions of retirement benefits. Further, the assets in the policy will be subject to creditor claims. To ensure that the desired retirement benefits are available for the owner/executive, the better solution is to establish an RCA with the contributions fully deductible to the corporation and with the funds growing over the long term safe from creditors until the retirement payments are required. Key man insurance should be purchased as required, but there is no significant economic or practical advantage in funding retirement benefits in the key man policy as compared to a properly funded RCA. ■

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HNW Entrepreneurs

with promising business prospects. "Sometimes your smallest clients grow and turn out to be your longest and best customers."

According to recent studies, many entrepreneurs recognize the value of advice, but not all business owners know how (or why) to get guidance. One recent study, conducted by TNS Canadian Facts for Scotiabank, reported that only 52% of recent start-ups created a formal financial plan; of those only 20% worked with an advisor to develop that plan.

"Having a plan in place is really key," says Brian Holt, Scotiabank's Director of Small Business Customer Relations. But a plan is just paper unless there are "appropriate advisors on board – advisors that can edit, plan, agree and help implement" future and current goals.

In that respect, advisors looking to tap the entrepreneurial market need to focus on how to provide long-term, overall planning, while offering specific advice tailored to a small business owner's stated needs.

In fact, tailoring is the key, explains Mark McNulty, co-author of *The Canadian Small Business Owner's Guide to Financial Independence* and a financial advisor at Ontario-based Raymond James–McNulty Group. McNulty, whose own book of practice is comprised primarily of dentists in the mature to decline phase of their business, helped build the McNulty Group practice through specialization.

"Every single plan is custom," explains McNulty. However, by specializing in a segment of the entrepreneurial market an advisor can reduce the workload of learning about an industry and speed up the process of learning about each client's specific needs and goals.

This specialization will also help an advisor understand the overall nature of entrepreneurs when it comes to money.

"In terms of investment process [most entrepreneurs] take a very conservative approach," explains Mark Kinney, a former executive at RBC Private Counsel and one of three co-founders of Newport Partners, a wealth management firm that specializes in servicing high-net-worth small business owners. For that reason, Kinney says, entrepreneurs have a different level of comfort with different types of investments – levels of comfort that are not akin to the responses of other types of investors.

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"Entrepreneurs take the biggest risk in their business because they feel in control, but these same risk-takers don't control the stock market so they don't necessarily like investing in stocks," explains Kinney. "We have found entrepreneurs like to invest in other private companies, real estate, and other investments they can touch and see. The choices [for investment vehicles] are really quite different [for the entrepreneur]."

Doug Brown, co-founder of Newport, adds, "entrepreneurs are good at running their business; they are not necessarily good at [financial planning] issues." That means it is critical for an advisor to bring all factors that impact an entrepreneur's personal and professional financial well-being to the table. If an advisor is not a specialist in certain fields, Brown suggests building a network. This network should include lawyers, accountants, tax specialists – any designation the advisor does not currently hold. Then the advisor, as the project manager for the entrepreneur, needs to develop a "cursory understanding" of all issues that affect the small business owner and how these designations can help.

This business model is how Newport Partners built $1.2 billion in assets in less than five years, working predominantly with high-net-worth business owners and their families.

According to findings of the TNS study, there is plenty of room for advisors, and their networks, to develop long-lasting relationships with entrepreneurs. Despite the importance entrepreneurs place on financial planning and advice, only 51% sought taxation advice from their professional advisor; only 16% sought business growth advice and a paltry 14% sought cash flow management advice.

"There is an old saying that grey attracts grey," says Brown. "As a young advisor it is unrealistic to assume that you will attract a seasoned company. It's companies like ours that deal with these clients. But if I was an advisor starting out, I would be working very hard to build those relationships with new entrepreneurs. These [owners] will be successful tomorrow and if you don't put the work in today, companies like Newport will try and get them when they are established." ■