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SERP Funding & Key Employee Retention

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As the current recession and economic crisis continues to grip world economies, large stable companies and small businesses are both feeling the crunch. Bankruptcy and mergers / acquisitions are now daily news stories. At the same time, other companies seem to be doing well, and continuing to grow. In the last RCF***News*** (Issue #20), we dealt with taxation and RCAs. This issue will focus on the employee's perspective.

Pension Shortfalls

Most pension consultants agree that an adequate pension should be no less than 50 to 70 per cent of an employee's final average annual income. As always, lifestyle, retirement plans, travel, other personal priorities, current assets, and potential inheritance are factors to consider when deciding on needs

Registered Pension Plans (RPPs) such as RRSPs, IPPs, or other Defined Benefit / Contribution Plans are not likely to meet the needs for those earning in excess of $125,000-$150,000 of income because of funding and benefit caps. To compound the problem, many Money Purchase RPPs have experienced substantial investment losses which may not recover in the years remaining to retirement. Dollar cost averaging would help if it were not for contribution caps.

As such, higher earning Executives/Key Employees will experience pension discrimination and reduced retirement income because they are limited to how much can be allocated into an RPP. If the Employer increases their income to compensate, the Executive is then taxed on income that otherwise could have been allocated to the RPP and, again on the investment earnings. Essentially, they experience double taxation on funds that they will not need until some point post-retirement.

The RCA Solution

The Retirement Compensation Arrangement (RCA), defined under subsection 248(1) of the *Income Tax Act*, fortunately addresses the pension shortfall problem. The contributions into the RCA Trust are 100% tax deductible to the Plan Sponsor (the Employer) and not taxed to the Employee /Executive until withdrawals begin from the plan at retirement. The only funding cap on an RCA is that the total benefit provided by the RCA and other RPPs do not exceed what are referred to as the "generally accepted guidelines" of 2% for each year of credited service or 70% for 35 years.

Security of a Funded SERP

Sadly, many retiring or retired Employee/ Executives of distressed corporations are waking up to a reality that their Supplemental Executive/ Employee Pension Plan is nothing more than a piece of paper since they are not funded. The security of the SERP Letter is dependent on the financial health of the companies behind the promise.

The courts have given very little consideration to "pension shortfall" guarantees from a company that enters into bankruptcy proceedings. For companies that are still profitable, Employees/ Executives should insist that their SERP be funded using the RCA provisions. There will be an impact to earnings, but it is shortsighted to have current cash earnings higher than they should be. Oftentimes, there is a distortion as to who shares in the company's bonus pool and those with unfunded pension promises.

Retention of Key Employees / Executives

Given the problems at company's like Nortel, GM, Chrysler, (to name a few), gone are the days that Employees/Executives will be satisfied with a promise that the company will top up any shortfalls from the company Registered Pension Plan. Ask any Executive from a now bankrupt company how they feel about any promised supplemental retirement benefit or even Stock Option Plans that are worth nothing. Paying large cash bonuses upfront does not create the kind of real long term incentive for an employee to stay with the company.

RCAs are based on final average earnings and years of service and become increasingly valuable over time. As such, they offer the ultimate incentive for the Employee/Executive to stay with the company. The Employee/Executive is rewarded from the cash profits of the company, and not dependent on the company's stock price at retirement.

Pension Funding Recovery

Over the past 2 years, many pension plans have experienced unprecedented investment losses due to the collapse of the global economy. In a Defined Benefit Pension Plans (DBPP), the Plan Sponsor does have the ability to fund the shortfall, and receive a tax-deduction for it. However, Plan Sponsor's of Defined Contribution Pension Plans (DCPPs) such as MPPPs or Group RRSPs are prohibited from making additional contributions to cover shortfalls from investment losses in plan.

Fortunately, investment losses from the DCPP can be recovered indirectly using an RCA. This is done by calculating the new pension shortfall associated with the DCPP as a result of the investment losses. This creates a larger RCA entitlement, thus allowing the Plan Sponsor to make a larger contribution into the RCA to fund the new and higher pension shortfall.

Salary Deferral Arrangement

The RCA rules were introduced in 1986, and up to 1996, RCAs were primarily used by public corporations with Defined Benefit Pension Plans (DBPPs) to fund the difference between the pension promised to the employee (on a formulae basis) and what could actually be funded in the DBPP which, at that time, were capped at $1,715 of annual benefit for every year of service (effectively covering a maximum of $85,750 of earnings).

RCAs were not used by private corporations or those with Money Purchase Pension Plans (MPPPs) since there was no promise to pay and RCAs can be deemed SDAs. This changed in 1996 with guidelines for Canadian Controlled Private Corporation (CCPCs) formally announced in 1998:

"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

The above was in response to a query as to whether a controlling shareholder of a private corporation could be treated as an employee for SERP purposes without the SDA rules being invoked.

Subsequently, the CRA and Department of Finance issued guidelines to the Canadian Life and Health Insurance Association in 2007 relative to Public Corporations.

"…the CRA has taken the position that a plan will not be treated as an SDA where the plan has the characteristics of an unregistered or supplementary pension plan and the amounts that may be paid out of or under the plan can be considered to be reasonable superannuation or pension benefit."

"The CRA generally take the position that supplementary pension benefits will be considered reasonable if the terms of the arrangement are substantially the same as those of the registered pension plan that applies to the same beneficiaries to whom the arrangement applies and the benefits that can be paid under the arrangements are the same as the benefits that would have been paid under the registered pension plan but for the defined benefit or money purchase limit."

CLHIA Roundtable 2007 (2007-0229361C6)

RCAs funded in excess of funding guidelines could be deemed SDAs. Some examples of SDA's include:

- Employee that reduces base salary to support contribution to RCA.
- Employee with base salary plus share of "bonus pool" must have T4/T4A earnings equal or greater than "pensionable earnings" used for entitlement calculations for RCA contribution.
- Arms-length employees with limited "past service" cannot be given unreasonable credits per year of future service.

The potential SDA concerns clearly require experienced professional advice when establishing funded SERPs. A properly designed SERP does not have to increase the overall compensation and benefit costs to the corporation.

Shareholder Rights

Many executives now view Stock Option Plans as not providing any real security at retirement. Given that there are few listed public companies whose shares have not dropped dramatically in the last year, the reality is that most retiring Key Executives with Stock Option Plans will find that the options will expire before the stock recovers to the strike price, let alone above it. As a result, looking at Stock Option Plans to supplement retirement income is unlikely to achieve the desired outcome. Further, Shareholders are more concerned that Stock Option Plans have not operated to increase the long term value of their shares and, therefore are not aligned with Shareholder's best interests.

Paying large Bonuses doesn't make an Employee any more loyal to the company. With Shareholders looking more closely at Key Executive compensation arrangements, they are questioning why the Executives are receiving such large bonuses. They may be justified if the Executive did well and made the company a lot of money in a given year. However, some Executive actions have resulted in a company losing money thereafter, as the bonuses were not structured to match long term shareholder interests. Accounting practices have resulted in earnings looking more positive in the short term, and bonus were increased without long term justification.

Shareholders have become more concerned over remuneration and incentive plans. It is appropriate that they are relative to long term performance, part of which can be reflected in SERP benefits.

An RCA Plan Document can be structured so that it encourages employee loyalty and is funded relative to real long term remuneration and encourage employee loyalty.

Conclusion

Looking after Key Executives/Employees is vital to continued success and growth of an organization. Providing a secured supplemental pension benefit that is not dependent on an unfunded promise or SERP arrangement is the way to provide the security for the Employee/ Executive. Retirement Compensation Arrangements are the only CRA accepted method to fund supplemental pension benefits. Employers looking to attract and retain quality employees to their organization need to implement RCAs, or else their competitors will.

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Pierre Ghorbanian is the Managing Partner of RCF. Case consulting with Advisors, Accountants, and Clients are his primary responsibilities. Pierre holds a Bachelor of Commerce (Hons.) degree from the University of Guelph, and he also holds the Certified Financial Planner (CFP®) designation from the Financial Planners Standard Council.

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