RCF News

ISSUE 4

Supplemental Executive Retirement Plans (SERPs) using Retirement Compensation Arrangements (RCAs)

By Roy W. Craik

What advantages do RCAs offer senior executives and why and how can they be used?

First, it is important to understand what an RCA is. Changes to the Income Tax Act in 1986 brought into being the RCA. Originally, the intent of this Legislation was to end a perceived abuse of Deferred Compensation Arrangements by private corporations. The definition of an RCA was contained in Sub-Section 248(1) and the relative sections of the Act were, in fact, a deeming provision.

Around 1987, large corporations in Canada with Defined Benefit Pension Plans (DBPP) began to realize that pension promises to higher paid managers and executives could not be totally funded by the DBPP and, as such, many executives did not have the security of a fully funded pension. The solution for many companies was to actually establish an RCA to secure and fund the difference between the total pension promise and that which could be funded and secured by the DBPP.

Not much thought was given to the use of RCAs for corporations without pension plans. There were two reasons for this. RRSP contribution limits supposedly would raise to $15,500 and be indexed to inflation beyond that, thus providing adequate pensions for those not in a DBPP. Secondly, there were concerns relative to the Salary Deferral Arrangement (SDA) provisions of the *Income Tax Act* for owners or key executives of private corporations. That all changed with the realization that RRSPs and MPPPs would not provide adequate pensions since contributions had not risen to the levels originally intended.

In 1998, the government, responding to the concerns raised by pension specialists and consulting actuaries as to pension adequacy of money purchase plans and the SDA provisions in the *Income Tax Act*, issued the following guidelines in a Round Table Discussion:

“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.”

The impact of this is significant for high earning executives. It meant that additional funds could be set aside for retirement on a formula basis to an RCA without the concern of the RCA being deemed a Salary Deferral Arrangement.

This meant that executives could receive:

1. Tax deferral to income tax rates at retirement on additional funds (under CRA guidelines) set aside for retirement
2. Tax sheltering of investment income on these funds using special products as assets of the RCA
3. Creditor protection

Compensation on a broad basis can have many components, such as:

1. Guaranteed salary
2. Bonuses
3. Life and health benefits
4. Base pension as per *Income Tax Act*
5. Supplemental Executive Retirement Plan (SERP) under generally accepted guidelines
6. Stock Option or Phantom Stock Plans

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

Not only can a SERP provide executives with the benefits outlined, it can be a valuable tool for the company in retaining key executives. SERPs can be designed in a way that there is not total vesting until the executive reaches normal retirement date.

SERPs secured and funded using the RCA provisions in the *Income Tax Act* can be designed and customized to fit the business model of the corporation. These can be on base salary over $100,000 where contributions range from 10% to 18% with optional contributions to increase final benefits up to "generally accepted guidelines." These optional contributions can even be split between the corporation and the employee on a 50/50 basis.

An executive with final total compensation of say $300,000 should look to a retiring income of 70% of this or $210,000 (indexed at 2%). Low contribution levels to RRSPs and MPPPs restrict the amount of final pension generated. As such, additional monies must be set aside to cover what is commonly referred to as the "pension shortfall."

Why pay tax on these monies if they are not needed until retirement? Investment earnings should be tax sheltered and common sense indicates that creditor protection should be sought.

A well designed SERP using the RCA benefits under the Income Tax Act can provide these results.

For owners of companies and for executives at or near retirement, the RCA can allow for substantial monies to be transferred from the corporation and not immediately taxed in the hands of the owner/ executive.

Taking an executive age 60 now retiring or wanting to fund all years of past service, the following lump sum contributions could be made based on the years of service shown and assuming average final compensation of $350,000 and a long term interest assumption of 5.5% (net of MERs).

Years of Service at Age 60	Lump Sum Deposit
30	$4,127,157
35	$4,815,017

These lump sum deposits provide the required pension of $210,000 (60%) or $245,000 (70%) to male age 82 with a 2/3 spousal survivor benefit and assume no integration with the RRSP and that there is no corporate pension plan.

For the same executive age 60 but not retiring for five years to age 65 with the same final average salary of $350,000 and 35 years of service, contributions of $792,330 could be made annually for five years.

RCA entitlement and funding figures vary depending on shareholder status, i.e. control or if there is a company pension plan.

Some corporations are using a point formula to determine the annual allocation to a funded SERP using an RCA. Points can be allocated as follows:

- 1 Point for each $10,000 of base earnings
- 1 Point for each year of age
- 1 Point for each of service

The corporation applies a percentage of performance pool (determined on a year by year basis) to various categories of executives which are contributed to the RCA on behalf of the executives providing they do not exceed the executive entitlement under CRA guidelines

This type of arrangement is being used to replace Stock Options plans, rewarding executives from increased earnings for shareholders and is expensed under guidelines in the Income Tax Act thus making the arrangement more shareholder friendly.

In conclusion, any company with high earning executives should at least know what RCA options they have since the RCA can be a very valuable part of a long term remuneration package.

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R^C^F is the creator of the RRSP***Wrap***™, IPP***Wrap***™, MPPP***Wrap***™ and PENSION***Plus***™. RCA trust services are provided by BMO Trust Company.

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