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# Ending Pension Discrimination For The Small Business Owner

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The ability of small to medium-sized corporations to offer meaningful retirement benefits to owners and key employees has seriously eroded in recent years. Pension consultants suggest that an adequate pension should be no less than 50 to 70 per cent of an employee's average income for the last three or five years prior to retirement. Lifestyle, retirement plans, travel and other personal priorities are all factors to consider when deciding on the appropriate pension amount. Most business owners are in for a shock when they see the small percentage of required pre-retirement income provided by an RRSP (Registered Retirement Savings Plan), RPP (Registered Pension Plan) or IPP Individual Defined Benefit Pension Plan).

RRSP contribution levels were originally based on the premise that an annual contribution of 18 per cent of salary would provide a business owner with an adequate pension. However, those currently earning more than $125,000 annually at retirement can expect to experience "pension discrimination" because of the existing caps on RRSP contributions. In other words, their pension benefits may be significantly lower than the acceptable standard of 50 to 70 per cent of pre-retirement income.

## PENSION DISCRIMINATION

To illustrate, let's look at a private business owner, age 45, currently drawing $200,000 annually from his company and with an RRSP balance of $150,000. If we assume his annual compensation will increase by five per cent to retirement, his final salary will be $505,390 and the final five-year average will be $459,496.

We'll compare his pension income with that of an executive working for a public corporation, who would usually receive a pension based on the following formula:

**Two per cent for each year of service to a maximum of 35 years x the final five-year average salary**

The current maximum pension allowed from a registered Defined Benefit Pension Plan (DBPP) for 35 years of service is $70,000. Most large corporations now provide executives with a Supplemental Executive Retirement Plan (SERP) covering the difference between the entitlement under the pension formula and what is paid from the pension plan.

If our private business owner had worked for a public corporation for the same 35 years that he had his business, he could expect a pension of $321,647 (70 per cent of $459,496). However, using an assumed rate of return of 5.5 per cent, and assuming maximum future RRSP contributions, his RRSP will only provide our private business owner with a pension of $101,535. He is a victim of "pension discrimination" in that if he worked for a large public corporation, he would be far more likely to end up with a pension of 70 per cent of his pre-retirement income. As it is, he experiences a pension shortfall of $220,112 annually!

## SOLUTION: A RETIREMENT COMPENSATION ARRANGEMENT (RCA)

Fortunately, the *Income Tax Act* provides a way to end pension discrimination for small business owners and their key employees. Subsection 248(1) of the Act defines a "Retirement Compensation Arrangement" (RCA). Contributions to the RCA are tax deductible by the corporation and there is no tax to the owner/employee until benefits are received from the RCA. There is no limit to the amount of corporate contributions to the RCA provided the proper pension entitlement calculations have been made.

## HOW AN RCA WORKS

Funds contributed to an RCA are divided equally between two accounts. The first is the RCA Investment Account (RCAIA). The second account is held and administered by Canada Revenue Agency (CRA) and is called the Refundable Tax Account (RTA). In additional, one-half of all investment earnings in the RCAIA must be transferred annually to the RTA. The funds held in the RTA, which earn no interest, are security for the tax that is currently deferred, but must ultimately be paid by the owner/employee when he or she begins to draw retirement income from the RCA. If tax rates are lower when funds are withdrawn during retirement, the tax paid, at that time, by the retired owner/employee will be less than the amount that would have been paid in tax if the funds had been paid out earlier as salary or bonus.

## SALARY DEFERRAL RULES AND INTEGRATED FINAL EARNINGS

In establishing an RCA, the pension entitlement calculations are very important.

If the calculations are overly generous, the CRA can deem the RCA to be a Salary Deferral Arrangement (SDA) with tax consequences and penalties.

To reduce the risk of the SDA concern, an Integrated Final Earnings approach should be used to determine the final entitlement to be funded by the RCA. This approach takes the pension from the business owner's RRSP into account. Initially, conservative index and investment rates are used, but they are recalculated from time to time based on actual compensation and returns. Contributions to the RCA are adjusted up or down accordingly.

In the case of an arm's length employee, the Integrated Final Earnings approach need only be used if there is a corporate sponsored Money Purchase Pension Plan (MPPP), DBPP or Group RRSP. Otherwise, the entitlement calculation can be made using a two per cent x years of service formula based on average final five years earnings. The employees personal RRSP is not part of the calculation.

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RCF 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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