

Retirement Compensation Arrangements

Supplemental retirement programs are often necessary because statutory plans may not allow highly paid executives to maintain a pension benefit commensurate with that received during their working years. For example, defined benefit pension plans currently provide for maximum pensions of approximately \$60,000, whereas money purchase pension plans and registered retirement savings plans have annual contribution limits (currently the lesser of \$15,500 and 18% of the prior year's earned income).

a) *Establishment of an RCA*

➤ An RCA is created if an employer:

- Makes a promise to an employee to provide a benefit in contemplation of retirement or loss of office.
- Establishes funding to fulfill the promise.

b) *Tax consequences*

➤ Once established, a trust is created and the following tax consequences occur:

- Contributions to the RCA by the employer are tax deductible to the employer.
- These contributions are not taxable income to the employee at the time made.
- Fifty percent of all income of the trust must be remitted annually as a refundable tax.
- Trust income is defined as:
 - Employer contributions.
 - All gains made by the trust.

Note: There is no recognition of different types of income, so capital gains and dividends are fully subject to the refundable tax.

- The tax is refunded when benefits are paid out to beneficiaries of the trust at the rate of \$1 refunded for each \$2 paid to the beneficiary.
- Benefits are fully taxable to the recipient as received under the terms of the trust.

c) *Comments on the Concept*

Historical Perspective

Generally, there are very few restrictions to the uses of RCAs. Investment options are wide open and there has been very little experience utilizing them. There are a few rules that have been developed around the administration of RCAs. The primary one that is pertinent to this discussion is that contributions must be reasonable. Unfortunately, there has been no definition of 'reasonable'.

It must first be remembered that RCAs were established to be punitive. They were created at a time when various executive plans were being established to take advantage of the disparity in tax rates between personal income tax rates and the generally lower tax rate enjoyed by many



employers. In fact, some employers had a zero tax rate (for example hospitals). Funds were being left with the employer for investment on behalf of the employee and to be drawn out later. The employer, due to the lower tax rate was able to invest larger amounts, on an after tax basis, than the employee was able to make. This created a larger fund at retirement.

The refundable tax is intended to eliminate this advantage and was originally an attempt by the federal government to create cash flow for itself now rather than later.

Employee Perspective

The attraction to an employee of the RCA is that the tax is refundable. If the employee anticipates being in a lower marginal tax rate at retirement rather than now there will be a benefit. The refundable tax will be returned to the employee in the form of benefits that will be subject to a lower tax rate.

d) When to Use the RCA

There are some very obvious situations where an RCA is useful.

- **If the employee is certain that retirement will occur with a residence outside of Canada**
Under current tax laws and treaties this will automatically create a lower tax rate at retirement. The funds can be withdrawn subject only to a 25% withholding rate – even on a lump sum basis
- **If the promise to pay is conditional**
In many cases the employer wishes to make the promise conditional upon the employee satisfying certain conditions – for example to remain with the employer for a period of time. The employee, on the other hand, wants to ensure the employer is able to fulfill the promise and asks for some form of current funding. This immediately creates an RCA (both parts of the concept are fulfilled). The advantage is that the funds are established and are kept in the trust separate from the employer's assets and not subject to the claims of the employer's creditors
- **Corporate and Shareholder Creditor Protection**
There are some instances where the shareholder / employee is concerned about personal and corporate liability. An RCA may provide an opportunity to set aside funds from the company. As the trustees are charged with providing retirement benefits this structure would provide some protection from the claims of both corporate and personal creditors. Obviously, this is not done when bankruptcy is imminent as the fraud rules come in to play.
- **The availability of an RCA allows employers to more easily attract and retain key executives.**
A funded RCA relieves the employer of a substantial liability in the future and will not burden the employer with public disclosure issues.



There are a number of situations where an RCA is contra-indicated:

- The employee's marginal tax rate is lower than 50% and does not anticipate being in a lower tax rate at retirement. For example, if the personal marginal tax rate is 45%, then for each \$1,000 of additional income the employee will have \$550 for investment. The RCA needs to remit \$500 of the same \$1,000 total contribution, leaving \$500 for investment. By taking the income personally the employee immediately has 10% more (\$50/\$500) to invest. Even though the tax is refundable, it generally does not offset this early advantage.
- Shareholder/employees should not generally consider an RCA. In most cases the employer is a private corporation where the first \$300,000 of taxable profits are subject to a tax rate in the low 20% range. It would be preferable to leave these profits in the company. In the event corporate profits exceed this, annual bonuses are paid to the shareholder/employee, the comparison in the above point applies.

e) Front End Leveraged RCA

This concept is a very aggressive tax-planning tool that relies upon the refundable tax account being an assignable asset. If it is an assignable asset, the RCA may create a method for up to 90% of taxable income to be returned to the company in the form of increased capital.

The company earns income and all or some of the highly taxed portion is contributed to an RCA. 50% of the contribution is paid to Ottawa as a refundable tax. The other 50% is invested in a secure investment in the RCA. The RCA finds a friendly lender that is prepared to accept the investment and the refundable tax as collateral for a loan up to 90% of the combined value. The RCA then applies the proceeds through an investment company to the operating company.

The conclusion is that the operating company has 90% of its before tax profits to apply to capital projects rather than 55%. There are a number of dangers to the concept:

➤ **Extra Interest Is Payable**

If no RCA is established and the company truly needs that full capital it can simply borrow a much lower amount than the RCA borrowing requires. If the tax is paid the company retains 55% of its income (63% if involved in manufacturing). The difference between the 90% borrowed by the RCA and the after tax cash now on the Balance Sheet if no RCA is used is 35% (27% for a manufacturer). The difference in interest payable on the two loans is rather considerable, even after allowance for tax deductibility.

➤ **Additional Insurance Costs**

One of the attractions of the leveraging concept is that the investment that is chosen is life insurance in order to provide the tax shelter that the RCA so badly needs. It is argued the tax free death benefit can be paid for by the company and when it is received it becomes a method of repaying the loan the company has acquired from the RCA. The problem becomes one of what happens if death does not occur prior to the time the proceeds of the RCA are required. For example, what happens if the business is continued by the next generation of family members. The RCA becomes a source of retirement income only if it is not encumbered by a loan.





Also the amount of life insurance required to maintain the tax shelter is usually significantly more than is required for the protection needs life insurance properly serves.

➤ **Loan Repayment**

If the loan is to be repaid prior to death it must usually be paid from the high tax income that it was desired to avoid.

➤ **Summary of Costs**

In the end the cumulative effect of paying too much interest and too much in life insurance costs and the probable need to repay the loans from after tax income that has been paid at the high rate makes many instances of Front End Leveraged RCAs economically unfeasible.

When to Use the Front End Leveraged RCA

- The concept works particularly well where the company already has liquid assets on hand that are designated for future capital needs. The transfer of the capital to a RCA to create the tax savings leaves 90% of the capital still available by way of loan from the RCA plus the tax savings in the company as increased capital to the company.
- If creditor protection is a concern but current capital is still required, the front end leveraged RCA provides some limited protection
- Proper distribution between a front end leveraged RCA and bonuses will allow enhanced current lifestyle while maintaining access to capital for the business
- Where the principals are quite young, the additional insurance costs are quite minor and do not impede long term true compounding of interest

RCA's may also be funded through a letter of credit or through a life insurance policy. The letter of credit's terms usually allow it to be called upon if the employer does not fulfill its obligations under the RCA. The contribution to the RCA is equal to the amount charged by the financial institution for issuing the letter of credit. A letter of credit is often viewed as a compromise between an unsecured arrangement and a fully funded RCA.

