

## EXECUTIVE COMPENSATION

# RCAs And Key Employee Retention

By: Pierre Ghorbanian

**A**s 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 continue to grow.

Given the nature of the business today, keeping valued senior employees through these difficult times is still a priority for employers. One valuable tool is a Supplemental Employee Retirement Plan (SERP) funded and secured through a Retirement Compensation Arrangement (RCA).

### 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, and current assets are factors to consider when deciding on needs.

Registered Pension Plans (RPPs) – such as RRSPs, IPPs, or other Defined Benefit (DB) / Defined Contribution (DC) plans – are not likely to meet the needs for those earning in excess of \$125,000 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, addresses the pension shortfall problem. The contributions to the RCA Trust are 100 per cent 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 two per cent for each year of credited service or 70 per cent 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 disparity between those who share in the company's bonus pool and those with unfunded pension promises.

## **Retention Of Key Employees/Executives**

Given the problems at companies such as 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 is not dependent on the company's stock price at retirement for their retirement benefits.

## **Pension Funding Recovery**

Over the past two years, many pension plans have experienced unprecedented investment losses due to the collapse of the global economy. In a DB plan, the plan sponsor is required to fund the shortfall and receives a tax deduction for it. However, plan sponsors of DC plans – including MPPPs and Group RRSPs – are unlikely to cover shortfalls from investment losses in the individual member's plan.

Fortunately, investment losses from DC plans can be recovered indirectly using an RCA. This is done by calculating the pension shortfall associated with the DC plan 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 pension shortfall.

## **Salary Deferral Arrangement**

The RCA rules were introduced in 1986 and, up to 1996, RCAs were primarily used by public corporations with DB plans to fund the difference between the pension promised to the employee (on a formulae basis) and what could actually be funded in the plan which, at that time, was 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 MPPPs since there was no promise to pay. This changed in 1996 with guidelines for Canadian Controlled Private Corporation (CCPCs) formally announced in 1998 which said "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 two per cent times years of service times final five-year average earnings or about 70 per cent of pre-retirement income for an employee with 35 years of service." This 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 Salary Deferral Arrangement (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 took 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." As well, it said it will "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."

RCAs funded in excess of funding guidelines could be deemed SDAs. These may be cases where, for example, employees have reduced their base salary to support contributions to RCAs.

Potential SDA concerns require 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 executives' 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, with increased bonuses 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.

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 their competitors will.

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