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Supplemental Pensions And Key Employee Retention

By: Allan Mosher

Most business owners will agree that the most important company asset is key employees. They will also likely agree that key employees and executives are vital to the transition and succession process (whether passing the business to children or selling to a third party).

How then to keep key employees/executives motivated and with the company to retirement?

In private companies, share ownership is often not an option. Cash bonuses are effective, but the portion they want to save for the future is often taxed at high marginal rates thus reducing asset growth. Of more concern, the employee/executive might build up savings from bonuses allowing them an earlier retirement. Key people could retire at 55 to 60 when the company needs them from 60 to 65, reversing the logic of a bonus as a retention arrangement.

Supplemental pension arrangements can be a solution. Often called SERPs (Supplemental Employee/Executive Retirement Plans), they provide the same deductibility to the company as a bonus, but for the employee/executive, personal tax can be deferred to retirement when benefits are taken. As such, asset growth is higher and personal tax rates might be lower at retirement. From the company's perspective, benefits commence at normal retirement age eliminating the concern of pre-mature retirements.

Importance To Employees

With the funding cap on registered retirement plans and low investment returns, there is great concern over retirement security, particularly for long service employees that could have experienced substantial equity losses in 2008. RRSPs or Group RRSPs do not allow for top-ups to offset losses.

Surveys show that employees rank pension plans as one of the most important benefits.

Enhanced retirement benefits from a company sponsored SERP can, therefore, be an important retention tool.

It is a win-win! Employees/executives receive greater retirement security in a more favourable tax structure. The company has more stability in the key employee with a longer retention horizon.

Target Benefit SERPS

Utilizing the retirement compensation arrangements (RCAs) provisions of the Income Tax Act, a group RCA is established for the key employees/executives. The company makes annual deductible contributions to the Group RCA segregated internally relative to benefits for each employee. A corporate trustee is appointed so all Group RCA funds are held separately from the company providing full security.

There are three benefit selections which the company can elect. These can vary by employee group and can be integrated with a group RRSP or other pension plan if desired.

- **Full Integration** - based on two per cent times years of service of final average compensation (three, five, or best five of 10) with no cap and integrated with other pensions.
- **50 per cent plan** - based on one per cent times years of service with no integration.
- **Guaranteed Level Benefit** - $2,000 to $5,000 monthly (cannot exceed 70 per cent of average earnings), adjusted for time value of money to retirement and indexed thereafter.

Key employee/executives enjoy the comfort of knowing they will receive guaranteed or adequate retirement benefits to provide them with 'living money' in retirement. Other investments provide 'play money.'

Vesting

Owners gain the advantage of structuring a vesting agreement that will ensure that key employees/executives remain with the company until retirement. It becomes increasingly expensive for another company to match benefits for senior employees as they get closer to retirement. Since succession or sale arrangements often hinge on the retention of key employees and executives, the advantage of a supplemental pension plan's vesting agreement is attractive. If it is a family business, the children gain the advantage of retaining the expertise of key executives for a period of time.

Mitigation Of Funding Cost

The third option is one of the most sought after by employees. If they are in a money purchase pension, they have great fear that their RRSP, group RRSP, or MPPP will not provide adequate minimum retirement benefits. Employees want/need at least some level of guarantees similar to what would be received from a defined benefit pension plan. The concern over DB is the investment risk to the employer and the liability for increased funding. This is why they have declined in popularity.

Registered pension plans are not allowed to own a mortality component on plan members but a group RCA can. The long-term investment risk is eliminated from the mortality guarantees on the individual contracts holding each member's share of contributions. Insurance companies today provide policies that can be structured to be used for retirement purposes providing both investment and mortality components, the latter for survivor benefits and funding mitigation.

In group RCAs, some members will live longer, others die short. New members are added as other members are closer to retirement or life expectancy. Some of the members will retire after other members have died.

Proper design allows for the security of the guarantee without the same risk and expense of a traditional defined benefit plan. Target benefit SERPs can be affordable and sustainable.

Owners

Controlling shareholders have many options to move funds from the company. For profits below the Small Business Limit (SBL), most times tax will be paid with dividends flowing upwards to a HoldCo.

For profits above the SBL, this is not now viewed as the best choice for all companies. Many accountants recommend profits over the SBL be paid by way of bonus given current tax treatment of eligible dividends and RDTOH (refundable dividend tax on hand) for non-sheltered investment income.

An option for part of these funds is the use of an RCA for the owner to CRA limits (providing a 70 per cent indexed pension integrated with other pensions). Since contributions to the RCA are deductible from pre-tax earnings the effect is to reduce profits over the SBL.

Owners can also increase retirement benefits to 100 per cent of final earnings by utilizing dividends from profits below the SBL that have been paid to a HoldCo.

Private owners are faced with various challenges. The good news is that there are new retention options for key employees and flexible options for their own retirement and security to meet these challenges utilizing supplemental pension strategies. Public corporations also have options as outlined in the August 2011 edition of *Private Wealth Canada* entitled '**SERPs In Public Corporations - Problems & Solutions**.'

*Allan Mosher is a senior vice-president of Retirement Compensation Funding (**almosher@rcf.ca**).*