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Ending pension discrimination against your organization's MVPs

Using retirement compensation arrangements to top up pension savings

By Peter Merrick

OVER THE past two decades companies operating in Canada have found it more and more difficult to provide worthwhile retirement plans to top people. For HR practitioners looking for a competitive edge in attracting and retaining executives and key staff, retirement compensation arrangements (RCAs) that create healthier compensation deals may offer that an edge.

RRSP limitations

In 1957 when the government introduced the RRSP, the premise was that an annual contribution of a business owner or executive of 18 per cent of their total income would provide an adequate pension. But with the limits placed on RRSP contributions, those earning more then $75,000 experience pension discrimination. These people's retirement plans will generate a much lower retirement income than the accepted 70 per cent of pre-retirement income, which is the rule of thumb.

Under the current RRSP rules, the most that anyone can save annually in an RRSP is $13,500. The federal government promises to increase RRSP limits to follow the industrial wage in the near future. However, for an organization's key people it's unlikely these increases will be enough to fund retirement incomes at 70 per cent of what they earned pre-retirement. Thus the more money employees earn beyond $75,000 per year prior to retirement, the greater the "pension discrimination" they face with traditional means.

Many CEOs, CFOs an HR managers are asking themselves if there are alternatives to replace lost retirement saving opportunities for themselves and their key people? The answer is yes. "Fortunately the Income Tax Act provides a way to end pension discrimination through the creation of Retirement Compensation Arrangements (RCA)," says Roy Craik, managing partner of Retirement Compensation Funding in Toronto.

An RCA can be wrapped around RRSPs and pensions to fund the difference between appropriate pensions for key people and what is provided through their defined contribution pensions, defined benefit pensions and RRSPs.

How do retirement compensation arrangements work?

An RCA is a plan defined in subsection 248(1) of the Income Tax Act, providing supplemental pension benefits to owners/managers and key employees. Contributions to a RCA are 100 per cent tax deductible by the employer and are not taxable for the employee until the money is withdrawn from the RCA.

Money that is invested into a RCA through a trustee is divided equally between two accounts. The first account is called the RCA Investment Account. The second account is referred to as the Refundable Tax Account, and this account is administered by the Canada Custom and Revenue Agency (CCRA). All funds in the Refundable Tax Account are refundable to the recipient of the RCA when they begin to withdraw their money.

Craik says that what makes RCAs so appealing to a company's high-salaried people is that in many cases their tax rates will be lower when the money is taken out of the RCA during retirement than the taxes they would have owed if their company had paid this money out to them as salaries or bonuses.

The example Craik uses to illustrate how pension discrimination places key people at a retirement savings disadvantage is the example of a 45-year-old executive who has an annual income of $200,000 and who holds $200,000 in personal RRSPs.

This executive can expect to see her income increase each year by five per cent until retirement. Her final year's income is estimated at $505,390 and her final-five-year average is $459,496. For RCA maximum funding in public and private companies, the federal government calculates that top earners can expect to get a pension of two per cent for each year of service to a maximum of 35 years, times the final-five-year average. This executive, after working 35 years for the company, using CCRA's RCA funding formula would be eligible for a pension of $321,647 (70 per cent of $459,496).

Using a conservative long-term interest rate of 5.5 per cent and making maximum RRSP contributions, this executive's projected annual pension with her current RRSP balance, will generate a retirement income from all plans of $95,632 annually to age 82.

Currently the maximum allowed to be paid out annually from a registered defined benefit pension for 35 years of service is $60,270. In this case, the annual pension discrimination is $226,015 ($321,647 desired pension minus $95,632 projected yearly retirement income).

There are only two methods of funding RCAs. At first RCAs were funded by purchasing within them T-Bills, GICs, Stocks, Bonds, Seg Funds, and Mutual Funds. With traditional RCA funding, one half of all annual earnings in the RCA Investment Account must be transferred to the Refundable Tax Account. The money held in the Refundable Tax Account is used as security for taxes that are deferred when money is held in the RCA. These monies will be ultimately refunded to executives or key people when they start to withdraw a retirement income from their RCAs.

A newer alternative uses tax exempt insurance, says Craik. Under this method, all of the income earned in the RCA Investment Account is tax sheltered in a tax exempt insurance policy until retirement when the money begins to be withdrawn. This provides a wide selection of investment options that are tax sheltered, resulting in superior long-term performance. Lastly, an RCA using this method is less complicated, and has lower administration fees than a conventional RCA or pension plan.

Should you use RCAs?

RCAs benefit top executives and key employees by ending RRSP and pension maximums discrimination. RCAs provide a disciplined and orderly way for employers to help key people fund their retirement in a tax effective way. RCAs do not affect RRSP or RRP contribution limits and there are no caps on how much can be contributed into them. Nor do they have any caps on the payouts to plan holders. Assets are held in-trust and are protected from creditors of the company and the individual.

But, RCAs are not for everyone, says Craik. They are best for owners, executives and key personal of a company with corporate profits of more than $200,000. They most benefit individuals between the ages of 35 to 50 with total incomes greater than $75,000 per year or individuals more than 50 years old with incomes of more than $100,000 annually.

If your company is planning or has made contractual promises to offer supplemental pensions or savings plans to attract or keep key people, an RCA that utilizes maximum tax benefits for your company and tax deferral for your key people is an option worth investigating.

Peter Merrick is a certified financial planner, specializing in creating employer/executive benefit programs. He can be contacted at (416) 677-6611, pmerrick@gpcapital.com or www.petermerrick.ca.

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