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What's happening with SERPs?

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SERPs, or supplemental employee retirement plans, are non-registered plans that are generally implemented when an employee's pension under a registered pension plan (a tax-exempt vehicle) is limited because of the maximum that can be tax-sheltered at law. SERPs will generally provide for the same benefit formula as the underlying registered pension plan, but will be reduced by the pension payable under the underlying registered plan. In this way, the employee will receive a pension on retirement based on his or her total compensation (as opposed to being limited by the maximums set out under the tax laws).

To Fund or not to Fund

There are various options with respect to the design and funding of a SERP. In some cases, the employer will agree to set aside funds to guarantee the payment of the SERP benefits. Such an arrangement would be a retirement compensation arrangement (RCA) for tax purposes. An RCA is subject to special rules under tax laws. Generally, any amount contributed to an RCA by the employer is subject to a refundable 50% tax, which is withheld at source. In addition, a 50% refundable tax must be paid on any income earned in the plan. When payments are made out of the RCA to the retired employee, then those amounts are taxable to the employee. To the extent that any payment is made from the plan for the employee's benefit, refundable tax equal to one half of the amount paid out is returned to the plan. An employee will generally favour an RCA as it provides security for the benefit promise.

SERPs may also be structured such that benefits are paid on a pay-as-you-go basis by the employer. In this case, the benefits promised are not pre-funded, so the arrangement would not be an RCA under tax laws. From the employee's perspective, this is not as attractive as there is no security for their benefit promise.

Potential Adverse Tax Consequences

There are instances in which SERPs are designed such that they provide for more generous benefits than the underlying registered pension plan. These types of plans have recently caught the attention of the Canada Revenue Agency (CRA). The CRA has taken the view that any "unreasonable" SERP benefits will be treated as a salary deferral arrangement for tax purposes. From the employee's point of view, this is not good—as a salary deferral arrangement the employee would generally be taxed each year in respect of the future benefits promised under the SERP (instead of being taxed when the benefit is ultimately paid out to the employee). From the employer's point of view, there could be penalties related to the failure to withhold and remit taxes.

At a recent conference, representatives from the CRA and Finance indicated that SERPs will be subject to salary deferral arrangement treatment to the extent that they provide unreasonable benefits. A SERP that mirrors the underlying pension plan (and deducts the amount payable under such plan) will generally not be considered to be unreasonable and therefore should not be subject to treatment as a salary deferral arrangement. The CRA has noted that it will consider certain factors in determining whether SERP benefits are reasonable, including: "the reasonableness of the benefits provided under the plan in comparison to the provisions of the registered plan that applies to the particular employees; the history of the employer in providing pension benefits; the comparability of the benefits provided to other employees of the employer or related employers under other arrangements; and the history of the employees' remuneration and any variations in that income as a consequence of the establishment of the arrangement."

From a legal perspective, it may be possible to challenge this position taken by the CRA. The CRA has yet to publish an official document with respect to this position; however, one is expected soon. It is also unclear whether the CRA will review existing SERP arrangements in light of this position. Certainly, where an employer plans to establish a new SERP, the CRA's view must be taken into consideration.

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