RCF News

ISSUE 1

Insurance Funded Retirement Compensation Arrangements – Who Qualifies

By Roy W. Craik

Tax-exempt life insurance policies have been used for many years to fund Retirement Compensation Arrangements (RCAs). An RCA is used to fund the difference between an appropriate level of pension for the employee and the income that can be generated from registered pension or savings plans. Although an insurance-funded RCA provides excellent retirement benefits for a successful private business owner or executive, not everyone qualifies. It's important to identify the candidates for this strategy carefully.

Bona Fide Employees

Candidates can be the owners or key employees of small to medium size businesses. They can also be executives of larger public corporations. In some instances, incorporated professionals can also qualify. Most importantly, the plan member must be a bona fide employee of the business. The provisions in the *Income Tax Act* relating to approved superannuation of pension funds or plans are applicable only where the fund or plan provides benefits for employees, officers or directors. This definition applies to anyone actively employed in a business and applies as well to owners, partners and other officers of the company who are paid for their services with salaries or commissions. Family members are eligible as long as there is a genuine employer/employee relationship and a salary or wage is being paid.

Annual Compensation Over $125,000

Ideally, the client's current salary should exceed $125,000 a year. An index rate is usually applied to the current salary when doing the pension entitlement calculation and this rate affects eligibility. A higher annual percentage increase boosts the final five-year average salary and therefore the pension entitlement.

Age 35 to 50

Retirement Compensation Arrangements work most effectively for business owners and executives from 35 to 50 years of age. However, plan members can be younger than 35 if they are earning significant compensation. Those aged 50 to 60 and over can still qualify for plans but may face reduced spousal benefits and/or pre-retirement death benefits, depending on deposit amounts.

Minimum Ten Years to Retirement

Unless withdrawals are deferred, it is important that there is a minimum of 10 years to retirement for any age, since it takes time for a significant accumulation to build up.

Company Income Higher than Small Business Limit

Generally, the company should be earning more than the small business limit under the *Income Tax Act*. Under current Federal Legislation, this will be a maximum of $300,000 depending on the province in which the corporation is registered.

Years of Service

Years of service with the corporation cannot include the time when the business was a sole proprietorship. However, if the plan member owned a company for fifteen years that was sold and subsequently enters a new and different business, the service in the first company cannot be included in the pension entitlement calculation. However, if an incorporated company is sold to another incorporated company and the plan member continues to work with the new company, the years of service with the old company can be included.

For example, if a plan member incorporated in 1985, sold the company in 1996 but stayed on as an employee with the new company, the years of service would be:

1985 – 1996 Owner/Employee	11 Years
1996 – 2003 Employee	7 Years
Total Years of Service	18 Years

RRSP/MPPP/IPP Balances

We recommend that clients maximize registered retirement and pension options before considering an RCA. For employees dealing at arm's length, RRSP balances do not have to be included in the pension entitlement calculation. If RRSP balances are not included, the supplemental pension entitlement is based on years of service x 2%. For example, an arm's length employee with 25 years of service could be provided a supplemental pension of 50% (2% x 25 years). His or her RRSP will hopefully provide at least the additional 20% to result in a 70% pension. However, if the employee is part of a group RRSP, an MPPP or an RPP, those balances are included in the calculation. This will obviously have the effect of reducing the contributions to the RCA.

Non-arm's Length

For the purpose of the pension entitlement calculation, non-arm's length means a controlling interest in the corporation either directly or indirectly through family members or a trust. If a corporation is controlled on a fifty-fifty percent basis by two non-arm's length owners, RCF would usually take the side of caution and include RRSP balances.

However, if the company is owned one-third each, we would not include the RRSP balances, except if the partners are husband and wife. Siblings owning less than fifty percent are considered to be dealing at arm's length.

For owner/managers not dealing at arm's length, current RRSP balances must be included at least to the level of benefit provided by an IPP. If they are also a participant in a company's RPP or have an IPP, all balances are included in the pension entitlement calculation.

Spousal RRSP balances should also be considered in making the calculation for owner/ managers not dealing at arm's length.

Mid or Late Term Hire

If dealing at arm's length, many companies will provide extra service credits for executives who are leaving pension credits on the table with their former employer. In the last Supplementary Employee Retirement Plan (SERP) survey done by William M. Mercer, the credit was 2 years for each year of continuous service.

What this means is that if a senior executive was hired at age 60, under the normal rules, the new corporation could only provide him with a 10% pension (2% x 5 years). However, with a 2-year credit for each year of continuous service, the pension would rise to 30%. The lowest age for mid-term hire adjustments that can be used for the 2-year credit is age 55. For service credits, the employee and employer must be dealing at arm's length and there should be evidence that the employee is leaving a substantial pension behind. In no case will years of service credits be allowed if the combined pensions from the former and new employer exceed 70%.

Minimum Deposits

The institutions offering RCAs also have minimum deposit requirements. The minimum annual PENSION***Plus***™ deposit is $50,000.

Of this amount $25,000 would be sent to the Refundable Tax Account and the remaining $25,000 would be deposited in the Life Insurance policy.

RCF is the creator of the RRSP***Wrap***™, IPP***Wrap***™, MPPP***Wrap***™, and PENSION***Plus***™. RCA trust services are provided by BMO Trust Company.

Retirement Compensation Funding Inc
416.364.6444 | info@rcf.ca | www.rcf.ca