RCF News

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Tax Sheltered vs. Conventional RCAs – What is the Focus?

By Roy W. Craik

When the first RCAs were established, they were used by large corporations to fund and secure what is commonly referred to as the "pension gap" being the difference between the total pension promise to an executive and what could be funded under company pension plans.

In most cases these were Defined Benefit Pension Plans (DBPP) where the benefit was defined and the company had a legal promise to pay, notwithstanding the funding cap on the DBPP. For example, a typical promise to an executive was a pension of 2% x years of service x final average earnings. If the executive had 35 years of service and final average earnings of say $200,000, the total pension promise was $140,000 (70% x $200,000) . The problem was that DBPP could only fund $60,270 ($1,722 per year of service now $2,111 per year of service). The "pension gap" or "shortfall" was a legal promise to pay (unless capped under pension documentation). Many companies viewed the "shortfall" as nothing more than a "pay-as-you-go" liability on a post retirement basis. However, this offered executives no security if the company went bankrupt.

Conventional Funded RCA

Conventional funded RCAs were not attractive to most large corporations since the corporation's tax rate was generally much lower than the 50% of each contribution that was held in the Refundable Tax Account (RTA). As well, not only were the earnings in the RCA Investment Account not tax-sheltered, there were no differences in the taxation of capital gains, dividends, and fixed income. 50% of all annual earnings had to be transferred to the RTA which earns no interest. To provide security, some companies established RCAs funded with Letters of Credit.

However, since CRA deems that a Secured Letter of Credit represents a contribution

to an RCA with the requirement to remit an amount equal to face value of the Letter of Credit to the RTA, this method of funding is restricted to only very large credit worthy corporations, whereby a bank will issue the Letter of Credit to the RCA without underlying security

Insurance Funded RCAs

The first insurance product to fund RCAs was designed by RCF in 1988 with Canada Life. Fixed Income yields were high in 1988 so the initial focus was to tax-shelter bond yields and to mitigate the loss of earnings on the RTA through mortality gains. With consulting actuaries providing the mortality assumptions, RCF's software configured the insurance product so that over a minimum time frame of 15 to 25 years (dependent on average age of group) RCAs could be made to perform close to the funding expectations of a DBPP.

1998 – A New Focus

Up to 1998, RCAs were seldom used for owners of private corporations, the reason being, the concern over the salary deferral provision of the *Income Tax Act*. CRA (then Revenue Canada) had the power from the introduction of the RCA legislation to deem an RCA to be a Salary Deferral Arrangement (SDA). It was in 1998 at a Roundtable discussion that then Revenue Canada set down guidelines for private corporations to establish RCAs and avoid SDA rules. Commonly referred to as the "generally accepted guidelines" as they follow the common formula used by public corporations "2% x years of service x final five year average earnings".

Canadian Controlled Private Corporations (CCPCs)

CCPCs pay a low rate of tax on earnings up to the small business limit, and higher rates on the excess which are further taxed as dividends when they flow through the retained earnings account. For this reason it is common in closely held private corporations to bonus down to the owners, earnings in excess of the small business limit. If the funds are not immediately required by the owner nor have to be reinvested back to the corporation, RCAs became attractive for owners. Many CCPCs also have pension plans for employees (usually MPPPs or Group RRSPs) that do not provide a desired level of pension. However, these plans cannot be mortality adjusted as large corporate pension plans.

PENSION*Plus*™ – *Insurance Funding for RCAs*

The insurance product designed for the use in RCAs for public corporations was not suitable for funding RCAs for private corporations. As well, to avoid the RCA from being deemed an SDA, it was important entitlement and funding calculations closely follow established guidelines. If insurance funding was used, the money transferred to the insurance company must also be equal to the contributions to the RCA Investment Account (RCAIA) net of Refundable Tax. This posed a problem because of the mortality component required to maintain the "exempt" status of policy.

A possible solution was to use split-dollar or shared-ownership of the policy between the RCA and the corporation, assuming that the corporation had some need for insurance and the cost could be justified. As such, the portion paid by the RCA would equal the contribution to the RCAIA if conventionally funded. However, Section 207.6(2) of the *Income Tax Act* and a technical interpretation dated May 31, 1988 relative to this section were cause for concern. The concern was that the proceeds of the life insurance would be taxed as income to the corporation and not pass through the Capital Dividend Account.

Although Section 207.6(2) and the 1988 Technical Interpretation do not apply to an individual, RCF also had concerns over a split/shared ownership between an RCA and individual.

In a Technical Interpretation dated September 16, 1993 relative to a shared ownership arrangement between a corporation and an individual, CRA indicated that they would deem the proceeds of insurance received by the estate to be a distribution from an RCA and subject to tax. CRA could easily extend that thinking to a shared/split ownership arrangement between an RCA and individual.

RCF decided that the only safe solution was to design a stand alone product for use in a RCA in which the insurance company receives the same funds as if conventionally funded. The result was PENSION***Plus***™.

Design Requirement and Focus

RCAs should not be established without the involvement of a client's accountant and lawyer. As such, it is important to be able to clearly show the accountant or lawyer the benefit of an insurance funded RCA over one using conventional funding on an apple-to-apple basis. The focus must be on the additional benefit provided by the tax-sheltering provided by the 'exempt' policy. In an RCA there are only two additional benefits that can be provided:

1. A pre-retirement death benefit
2. increased survivor benefits

Additional Survivor Benefits

Using our generic case study as an example (*available at www.rcf.ca*) the annual contribution to the RCA for 20 years was $141,270 providing a primary benefit at age 65 of $218,882, indexed at 2% to age 82. However, if taken on a joint-last survivor basis, the benefit from age 65 to age 82 drops to $173,215 with the surviving spouse receiving $161,776 indexed at 2% from her Age 79 to 86.

Obviously, survivor benefits do not kick in until a plan member dies. RCF's PENSION***Plus***™ is designed to bring back into the RCA tax-free; all of the tax sheltered earnings form the date of the plan inception to the plan member's death.

The result is that the survivor benefit is $204,346 (assuming the plan member death at age 82) an increase of $42,569 annually indexed at 2%. As well, the plan member does not have to take a reduced primary benefit to produce the increased survivor benefits meaning increased primary benefits of $45,667 annually indexed at 2%.

The client and accountant and/or lawyer can see clearly that insurance funding provides substantial benefits at the same cost of conventional funding with no need for split/ shared ownership.

Pre-Retirement Death Benefit Option

It is given that those establishing RCAs hope to enjoy the benefits. As such, the focus here is living long as opposed to dying short. In the example given the death benefit at age 82 is $1,444,529 as compared to the cash value the day before death of $1,303,947, a difference of only $140,582.

PENSION***Plus***™ is designed to cut the insurance amount down to the lowest possible amount to keep the policy 'exempt' from accrual taxation. As can be seen, there is no need for split/shared ownership at normal life expectances.

Up to retirement, PENSION***Plus***™ utilizes inexpensive Yearly Renewable Term (YRT) as the veneer wrapped around the cash component to keep the policy "exempt". Since the insurance company is receiving the same funds that would go into a conventionally funded RCA, the pre-retirement death benefit that the RCA would receive if the primary beneficiary is used as the life insured, is at no additional cost to the RCA. As such, this benefit can be important particularly for RCAs for employees. Often times, the employee's are much younger then their employee/owner. PENSION***Plus***™ has been designed so that if the plan member dies prior to retirement, the survivor can receive the same pension had the plan member lived to retirement, and the RCA had been funded to retirement. This is an important benefit for employees.

Conflict of Interest

The new conflict of interest rules for the insurance industry raise problems. Why has a specific insurer been picked? R^{C}F's PENSION***Plus***™ eliminates these concerns for insurance funded RCAs. With the PENSION***Plus***™ platform, all insurers receive the same funds, payout the same primary benefits and provide the required funding for the survivor benefits.

As such, the decision to pick one insurer over another is relative to the underwriting and investment options which can be easily explained to a client.

Conclusions

The benefits of using an insurance funded over a conventional funded RCA can be substantial.

R^{C}F's PENSION***Plus***™ provides a level platform for most insurance companies that is compared with conventional funding with a matching RCA ledger. To recommend to a client a conventional funded RCA without also showing the benefits of one with insurance funding could lead to trouble. As a rule of thumb, 10 years before benefits begin are required for insurance funding to provide increased benefits over conventional funding. A conventional funded bridge can also be used with insurance funding to produce additional benefits.

Roy W. Craik, President
Retirement Compensation Funding

R^{C}F 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