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Funding Retirement Benefits – Retirement Compensation Arrangements vs. Corporate Insured Retirement Programs

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Introduction

With increased salaries and bonuses and with RRSP contribution levels, and registered pension contribution or benefit levels that have not kept pace, many owners/executives and executives are finding that the amounts available as a pension in their retirement fall far short of the 70% of their best or last five year average remuneration, which most actuaries and pension specialists suggest as being necessary to continue the executives' standard of living. The difference between the pension provided by the RRSP or pension plan and the 70% pension is referred to as the pension shortfall.

The RCA

The government has established the required method for the funding by the corporation of pension shortfalls which is the Retirement Compensation Arrangement (RCA) provision set forth in section 248(1) of the *Income Tax Act*. RCAs are plans whereby an employer makes contributions of funds for an employee to a custodian or Trustee to be distributed on the employees retirement, loss of employment, or substantial change in the services provided by the employee. The RCA functions like a pension plan except that half of the contributed funds and half of the earnings are held by the CRA in a separate account earning no interest called a Refundable Tax Account (RTA).

An advantages of a properly established RCA is the creation of a separate fund safe from creditors providing long term tax deferral. The contributions are tax deductible to the corporation and not taxed to the executive until received in retirement. If an exempt insurance policy is the asset of the RCA, the investment earnings are sheltered and there are no contributions of income to the RTA. The life insurance also provides completion of the pension in the event of demise before retirement, and the use of special software allows mortality costs to be adjusted and held to a minimum so that the insurance costs do not impair the performance as compared to a pool of investment assets in the RCA.

The Corporate IRP

The Corporate Insured Retirement Program (CIRP) is the purchase by the corporation with after-tax dollars of a universal life insurance policy with premiums sufficient to create a fund to pay the required retirement benefits, and a death benefit to be received tax-free by the corporation allowing for the payment of tax-free capital dividends. The normal method of providing the funds to pay the retirement benefits is to have the corporation borrow against the policy (leveraging the policy) to provide funds which are then paid to the owner/employee as a taxable benefit or are paid as a dividends to the owner/employee and taxed as such. As banks do not loan 100% of cash surrender values, funding for the policy must allow for policy values considerably in excess of the anticipated retirement funding. Futher, the availability of the loans at retirement can impact the leveraging strategy. Of course, the company can borrow the funds for the retirement benefit from the insurance policy, but that would constitute a distribution from the policy which would be taxable in whole or in part as income to the company depending on the adjusted cost basis of the policy.

The presumed advantage is that the corporation can use a policy which is purchased as Key Man Insurance or to assist in a family buyout to also provide retirement funds for an owner/executive.

What CRA Have Said

In establishing the RCA rules, the CRA recognized that corporations might seek to use insurance policies like the CIRP strategy to fund retirement benefits for owner/executives, and avoid the RCA requirements. Therefore, the RCA provisions include section 207.6(2) of the *Income Tax Act* which provides that:

"where an employer is obligated to provide retirement benefits that are to be enjoyed by any person after retirement of a taxpayer and where the employer acquires an interest in a life insurance policy that may reasonably be considered to be acquired to fund in whole or in part those benefits, the person that acquired the interest is deemed to be a custodian of an RCA; the interest is deemed to be the subject property of the RCA; and an amount equal to twice the premium is deemed to be a contribution to the RCA; and any payment received in respect of the interest is deemed an amount received out of the RCA."

If the policy is deemed to be an RCA, then any death benefit which the corporation receives on the policy would be a distribution from the RCA, would be taxable, and would not be received tax free.

The CRA's RCA Guide (T4041) specifically discusses insurance policies purchased by a corporation to fund an employees retirement benefit and notes that under 207.6(2) **"the payments under the [insurance] policy are distributions by the arrangement"** and therefore taxable as such.

Marketers of CIRP say that the Key Man aspect of the CIRP should be emphasized and that illustrations of retirement payments should "disappear". However, the actual record of borrowings and retirement payments will create an evidentiary background of interest to the tax auditors. The CRA is aware of CIRPs, some of which are now of sufficient duration for retirement borrowings to commence. It is to be expected that the CRA will encourage actions, by its tax auditors, or by changed legislation to ensure that section 207.6(2) is not evaded.

Conclusion

The purpose of the CRIP in providing Key Man Insurance with the tax-free death benefit allowing tax-free capital dividends would be prevented if the policy were found to be a deemed RCA under 207.6(2) due to the provisions of retirement benefits. Further, the assets in the policy will be subject to creditor claims. To ensure that the desired retirement benefits are available for the owner/executive, the better solution is to establish an RCA with the contributions fully deductible to the corporation and with the funds growing over the long term safe from creditors until the retirement payments are required. Key Man Insurance should be purchased as required, but there is no significant economic or practical advantage in funding retirement benefits in the Key Man policy as compared to a properly funded RCA.

About the Author

Carl Rosen is the Senior Vice-President of RCF, and is responsible for legal requirements in plan design, establishing trust arrangements, monitoring of documentation, and due diligence. Carl has degrees from Williams College, a post-graduate degree in Economics from Oxford University, and a Law degree from Yale Law School.

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