TD Wealth

Executive Income

Filling the pension gap

High income earners will often seek ways to supplement their retirement income, beyond Registered Retirement Savings Plans (RRSPs) or standard employer pensions. There are a few options available to them to fill the 'pension gap' and fulfill their goals.

Retirement Compensation Arrangements

A Retirement Compensation Arrangement (RCA) is a usually funded by your employer. You may also contribute, depending on the agreement you have with your company, but your contributions cannot be larger than your employer's. The benefits are paid to you when you retire, your job terminates, or you have a substantial change in roles, for example, a senior executive to a part-time consultant.

Good candidates for an RCA include business owners and key executives, who earn a sizeable six-figure salary (e.g., $200,000 or more). The general rule-of-thumb is that your retirement income should be 70% of your working income. As an executive, your RRSP and company pension could easily add up to *less than* 70% of your salary. An RCA could fill the gap to 70%.

For business owners an RCA can also be a good vehicle for reducing the company's income to fit within the annual small business deduction limit of $500,000. Rather than having excess business income taxed at a higher rate, the money could be transferred into the RCA, immediately deferring tax — and continuing to do so until it is withdrawn by the retired executive.

Annual contributions are paid into an RCA trust, managed by a "custodian" (trustee, e.g., a trust company), for the employee based on a pre-determined amount or formula. Contribution amounts must be set out in the trust agreement, as agreed by the employer and employee. While the Canada Revenue Agency (CRA) does not put specific constraints on contribution amounts, it may be prudent to ensure they are reasonable, for example, within 70% of the employee's income. An RCA can hold a variety of investments, such as: cash, shares, bonds, T-bills, and GICs.

Funding an RCA with a life insurance policy

RCA contributions are 100% deductible for the company and in most cases for the employee. The contributions are not considered a taxable employee benefit. The funds are not taxed in the employee's hands until they are withdrawn from the plan.

The main detraction of an RCA is how it is maintained in concert with CRA rules: 50% of any contributions made to the plan by the employer and employee and 50% of income made inside the plan (interest, dividend, capital gains) are remitted to the CRA to a *refundable tax account* (RTA). Then when you make withdrawals from the RCA trust, the CRA will refund a dollar for every two dollars withdrawn — until the RTA is depleted. It should be noted that funds kept inside the RTA account do not earn any interest. This is another downside of an RCA as a retirement planning vehicle.

An RCA can also invest in a life insurance policy, as long as policy benefits are within certain prescribed limits as set out in the federal *Income Tax Act* (ITA), and are based on reasonable actuarial calculations. For example, investment income earned by a universal or whole life policy (typically held within the cash value portion of the policy) will grow on a tax-deferred basis and not be subject to the refundable tax, though the CRA could deem the planholder to be in receipt of an *advantage that may be taxable*. Upon the planholder's death, the policy death benefit will not be taxed when received by the RCA. However, it may be taxable when distributed to the planholder's beneficiary. Notably, if the policy was purchased by the company, it cannot distribute the death benefit through its capital dividend account as a tax-free dividend.

RCAs are common retirement planning tools for high-income earners, but they are complex to set up and maintain. The tax rules around them are equally complex. What investment would you wish to hold in an RCA? A life insurance policy? It is recommended that you speak with your TD advisor and tax specialist before proposing an RCA as part of your compensation package.

You will wish to ensure the most tax-effective method of funding the RCA is put in place. If you are looking at life insurance as a way to fund your RCA, you could consider speaking with a TD insurance specialist.

Supplemental Employee Retirement Plans

Another tool for high-income earners is a Supplemental Employee Retirement Plan (SERP). They are known as "top hat" plans, since they are meant to top up a key employee's pension without the same *ITA* imposed contribution limit as registered pension plans.

> A SERP can either be funded/secured or unfunded.

A SERP can either be funded/secured or unfunded. Generally for SERPS that are not funded, your employer will provide a letter or formal agreement to top up your retirement benefits upon retirement. There will be no tax liability for either party or a deduction for the employer.

A funded or secured SERP will be deemed by the CRA to be an RCA, and treated accordingly (i.e., the application of RTA).

However, despite the establishment of the SERP, there is a risk the employer will not come through with the funds, intentionally or because it will not have the funds when you retire to do so. Proper documentation of a SERP is crucial to binding the employer legally. If necessary, you may have to use it in court to compel your employer to pay up.

Are you looking to top up your retirement income? Perhaps a SERP is for you. However, you need to ensure you have proper documentation of the company promise to pay. You need to be comfortable with its ability to fill its promise. If you think a SERP might be a retirement planning option you would like to present to your employer, consider speaking with a tax specialist.

Individual Pension Plans

An individual pension plan (IPP) is another retirement planning tool that can be used to fund retirement income for business owners and key executives.

Generally, one of the planholders will be a "connected employee", owning more than 50% of the company's voting shares. An IPP can have a max of 3 members and one member must be related to the employer.

Unlike an RCA or a SERP, an IPP is a defined benefit (DB) pension plan but with generally one member. There are prescribed maximum benefits that you can accrue for each year of service. The legislated limit is 2% of earnings, which includes salary, commissions, bonuses and any taxable benefits, though not dividends.

An IPP will have the same impact on your RRSP as a DB plan.

Like all DB plans, an IPP must provide a lifetime of retirement benefits. For that reason, an IPP must be assessed by an actuary every few years in accordance with the applicable pension legislation. And like any DB pension, an IPP may be in a deficit or surplus position. Pension legislation will mandate the employer to make up any deficit. Any surplus can be reduced.

An IPP will have the same impact on your RRSP as a DB plan. A pension adjustment for the funds placed in your IPP will be applied against the annual 18% maximum you can contribute to your RRSP. It's possible that your IPP contributions will completely eliminate your RRSP contribution room.

If the IPP is terminated because you depart from the company, the funds cannot generally be cashed in. Instead, they must be transferred to a Locked-in plan, such as a Life Income Fund (LIF). The *ITA* limits the amount that can be transferred from a DB plan to a registered plan. Any excess may be subjected to tax.

Some of the benefits of an IPP include:

- The retirement income will be predictable
- Higher contribution room is generally permitted for people over 40 in an IPP than an RRSP; under the *ITA*, the older you are, the greater your contribution room
- Lump sum contributions for past service can be made back to 1991
- The corporation can borrow to fund the IPP on a tax-deductible basis; that's not possible if you want to borrow to help fund your RRSP
- Assets held in an IPP are generally protected from creditors
- Income-splitting with your spouse or common law partner is permitted when pension benefits are paid out

If you die before retirement, your surviving partner is given the option of purchasing a deferred annuity or transferring the commuted value of the IPP to a registered plan, depending on the applicable pension legislation. If there is no partner, the proceeds will be distributed to the estate or a named beneficiary and be subjected to tax.

If you die after you retire, the IPP funds will be distributed based on whether your pension was being paid from the IPP or the funds were transferred to a registered plan.

If you intend for a family member, such as a daughter or son, to take over the business when you die, an IPP can be an ideal way to keep funds out of your estate and in a tax-deferred vehicle. Your son or daughter can be added as a member of the existing IPP.

There are pros and cons to all retirement plans for high-income earners. Is an IPP for you? Is your company willing to set up and maintain an IPP for you? Speak with your TD advisor and tax specialist to weigh the options and implications.

Now you can speak with your TD advisor about:

- **Speak with your TD advisor and your tax specialist to review and decide whether the most common retirement plans for high-income earners — RCAs, SERPs, IPPs — are right for you.**
- **Make a decision to speak with your employer about the plan you are most comfortable with.**

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