Supplementary Pension Plans

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Supplemental Employee Retirement Plans (SERPs) – Canada
Development of Current Position

• Historically (pre-late 60s – 1990s), no legislation requiring pension plan pre-funding
• Starting in 60s, varies by province, legislation requiring pre-funding
• “registered” pension plans can be funded only to certain limits to benefit from tax support
  • Currently first $150,000 CAD is pensionable in DB plan
  • Max $26,500 CAD can be credited to DC plan
Development of Current Position

• Tax effective to enrol high earners in registered plan to cover earnings up to registered limits; add a SERP on top

• Plans providing pensions on earnings over registered limits not restricted by minimum standards, and don’t need to be funded but plans providing ‘over the limits’ benefits get no tax support

• Can provide ‘over the limits’ (OTL) pension promise without immediate tax inclusion – two options
OTL Pensions – Two Options

• Option 1: promise to pay is unsecured and backed only by contractual obligation (Pay-as-you-go)

• Option 2: promise to pay is secured or partially secured through a ‘retirement compensation arrangement’ or RCA
  • Secured with cash (partial or full)
  • Secured with letter of credit (partial or full)

• RCA rules formalized in Income Tax Act
OTL Pension Options

• Option 1 (unsecured) simple to document, but must be fully accounted for

• Option 2 more complex to document
  • Usually a written contract or written plan text
  • Trust established, usually with a trust corporation
  • Cash investments or letter of credit held in trust
  • Employer usually pays OTL pensions directly or through pay agent
Retirement Compensation Arrangements

• Assets must be deposited with a custodian – trustco, lifeco or individual trustees

• Must pay a refundable tax = 50% of all deposits and investment returns

• Refundable tax account releases funds when monies paid from trust

• Refundable tax earns no interest or return
Retirement Compensation Arrangements: Pros / Cons

• The higher the marginal tax rate in jurisdiction, the more a 50% refundable tax makes sense

• Refundable tax regime make contributions and pension payments from RCA trust awkward

• Letter of credit often a preferred choice, but must tie up credit and pay fee to obtain – CRA expects remittance of refundable tax = 50% of fee
SERPs – More Recent Trends

• Until 2003, tax limits for Registered Pension Plans frozen for many years – many higher income non-executives hit the limits

• Result was more SERPs, and the ‘E’ in SERP became ‘Employee’ instead of Executive

• Some companies had enough high earners to justify registered executive plan to maximize registered pensions and coordinate closely with SERP formula
SERPS – More Recent Trends

• Until 2004, tax limits have risen again – now linked to cost of living index
• Marginal tax rates also fell during same period
• DB plans disappearing rapidly during same period
• Result was:
  • Higher tax limits reduces # of eligible members
  • RCAs less tax effective as tax rates fell = fewer RCAs
  • Fewer DB plans mean fewer DB OTL plans needed
  • OTL DC plans becoming relatively more common
Current Status

• RCA rules have been static
• Some rumors of tightening of RCA rules, but not affecting arrangements that are legitimate pension plans
• Concern that SERPs whose terms are different than base plan are at risk of regulatory attention
• Marginal tax rates in Canada are going up, so SERPs becoming more tax effective again
• Registered pension limits still going up with cost of living – no apparent threat to indexing of tax limits on horizon
SERPs for Cross Border Businesses

• Not uncommon for Canadian based public companies to have mix of Canada and US based executives

• Not uncommon to have secured SERPs for Canadian executives and unsecured SERPs for US executives in same company
Abuse of RCAs

- Aggressive tax planners have devised ways to use RCAs to shelter small business capital
- Tax authorities have cracked down
- Periodically, some worry that a crackdown on ‘legitimate’ SERPs using RCA rules coming, but hard to argue there is much tax leakage
SERPs in Insolvency

• Often, in bankruptcy, DB pensions are cut – several recent high profile examples – Nortel, SEARS department stores, etc.

• SERPs often secured by letters of credit up to whole amount of liability

• On insolvency, trust agreements require trustee to draw on letter of credit to fully fund the SERP; issuing bank is usually a secured creditor

• Thus, can see situations where executive pensions are safe in insolvency, while ‘rank and file’ employees face pension cuts
Future of Canadian SERPs

• No material legislative/tax changes on horizon
• Limited pressure exists to raise tax limits faster than cost of living
• No pressure to tax SERPs more heavily
• No pressure for immediate income inclusion of secured SERP entitlements
Alternatives

• Some employers will create after-tax savings accounts for high earners-taxed as income when set aside – no tax advantages

• Another approach is to create a RCA retirement plan that promises to pay out over 10 or 15 years, instead of life – not a ‘pension’ plan so can exist not as an OTL plan – no need for a registered plan underneath
Supplemental Pension Plans – United States
US Supplemental Pension Plans: Types

• Defined Contribution
  • Excess benefit – supplements broad-based DC plan contributions
  • Other formula – e.g., bonus deferral

• Defined Benefit
  • Excess benefit – supplements broad-based DB plan benefits
  • Other formula – e.g., higher income replacement

• All usually unfunded to avoid current taxation
Basic US Income Tax Rules

• In general . . .
  ▪ Cash compensation is taxed for the year in which it is received (generally the same as year paid)
  ▪ A compensatory transfer of stock or other property is taxed the same as cash, generally considered “paid” when any substantial risk of forfeiture ends
  ▪ An employer can take a tax deduction for compensation for the same year in which the employee is taxed on the compensation
Basic US Income Tax Rules (cont’d)

• Special rules apply to . . .
  ▪ “deferred compensation” arrangements, which pay compensation in the future for services performed by employees today; and
  ▪ certain kinds of equity-based compensation, including stock options and restricted stock

• Note:
  • Social Security contribution and similar federal taxes apply earlier than income taxes for vested benefits
  • State tax treatment may differ from federal
Principal US Laws

• Internal Revenue Code Section 409A
  • Governs the income tax treatment of most deferred compensation arrangements

• Internal Revenue Code Section 457
  • Adds special rules and exceptions for tax-exempt and governmental employers

• Employee Retirement Income Security Act (ERISA)
  • Provides conditions for exemption from participation, benefit, funding etc. requirements for broad-based pension plans
Section 409A

- Provides a broad definition of deferred compensation plans and arrangements
  - Deferred compensation means an executive obtains a *legally binding right* in one year to compensation payable in a later year (even if conditions or contingencies apply)
- Establishes strict rules governing deferral elections and payment elections by service providers
  - Election rules apply whether or not executive has any choices
- Restricts benefit payment timing and prescribes “permissible payment events”
Section 409A (cont’d)

• Imposes significant tax consequences on covered executives – not the employer – for violations
  • Deferred amounts taxable as current compensation, with penalties and interest for past years
  • 20% excise tax may be added
• Formal corrections possible but somewhat limited
Section 409A (cont’d)

• Key exceptions to Section 409A
  • Short-term deferrals – paid within 2 ½ months after close of the taxable year in which vested
  • Certain separation pay arrangements
  • Certain stock options
  • Broad-based, tax-compliant retirement and annuity plans
Section 457 – Exempt Organizations

• Section 457(b)
  ▪ “Eligible” deferred compensation plans
  ▪ Subject to dollar limits and distribution requirements
  ▪ Nondiscrimination rules do not apply

• Section 457(f)
  ▪ “Ineligible” deferred compensation plans
  ▪ No dollar limits or nondiscrimination rules
  ▪ Benefit is taxed when it vests
ERISA Top Hat Plan Exemption

• Executive deferred compensation plans must qualify for this exemption to escape most ERISA requirements for broad-based plans

• Top hat plan participants belong to “a select group of management or highly compensated employees”
  • No bright line test to determine a good top hat group - guidance generally gleaned from case law

• Benefits must be unfunded
  • Notional account within employer assets
  • Rabbi trust, subject to employer’s general creditors in event of insolvency
US Supplemental Pension Plans: Tax Reform

• Rate Reduction and Deduction Changes
  • Top Marginal Rate Reduced From 39.6% to 37%
  • Deletion of State and Local Tax (SALT) Deduction

• No Changes to IRC Section 409A Tax Deferral Rules

• Changes to IRC Section 162(m) Deduction Limit for Certain Executives
US Supplemental Pension Plans: Regulatory

• Dodd Frank

• Proposed Clawback Rules

• Trump Regulatory Freeze
US Supplemental Pension Plans: Miscellaneous

• Litigation Issues
  • Forfeiture for Cause, Non-compete, Confidentiality
  • ERISA Exemption for “top-Hat” Plans

• Shareholder Issues
  • Say on Pay
  • ISS Guidelines
Supplemental Pension Plans – France
French employee’s retirement system: principles

- **Mandatory basic scheme, statutory pension**
- **Mandatory complimentary pension scheme** « AGIRC / ARRCO »
- **Company-level pension scheme, Optional systems**
French employee’s retirement system: principles

- **Company-level pension plan**
  - Optional retirement pension scheme
  - Mandatory or optional membership
  - « Art 83 »: defined contribution pension
  - « Art 39 »: defined benefit pension (differential or additional)

- **Mandatory complementary pension**
  - ARRCO (non executive employees’ pension fund)
  - AGIRC (executive employees’ pension fund)
  - Contributory pension scheme
  - Intergenerational solidarity / pay-as-you-go scheme
  - Joint institutions (fusion project in 2019)

- **State pension**
  - State retirement pension
French employee’s retirement system: statistics

• Less than 3% of the global pension comes from the optional system
Supplementary retirement system: setting

**Company** Subscriber
Employer

**Supplementary Scheme**
- collective agreement between trade unions and employers (or employer associations), collective bargaining agreement,
- (Or) referendum agreement,
- (Or) employer resolution,

**Insurer**

**Employees**

**Works council**
- information, consultation
Supplementary retirement system: setting

Distinguish:

The « scheme » or « plan »...

which refers to the company’s undertaking, organized by the collective rules of labour law (cf. law n° 94-678, 8/081994, art. L.911-1 and f. FSSC)

... of the insurance coverage

that is to say the insurance policy subscribed in order to apply the scheme

Therefore a policy that does not cover all of the company’s obligations can give rise to an unidentified social liability (cf. cass., soc. 03/06/1997, Haribo-Ricqlès-Zan c/ Delpine),
3 types of supplementary pension plans

• Defined contribution plans
• Defined pension plans
• PERCO which is:
  • An optional type of employee savings
  • Put in place by the employer
  • In order to complete the mandatory pensions
Define contribution plans: main rules

• Collective pension system which benefits all employees or only a category of them (often for the managers)
• The contribution can be partially paid by the employees
• The only obligation for the employer is to pay the contribution to the insurance company: the employer does not determine the amount of the pension and has no liability if it is lower than expected.
• The employees gain a right to obtain the pension even if they leave the company (the amount of the pension will depend on their length of service)
Defined pension plans: main rules

• Collective pension system which benefits mainly executives
• The employer has to have set beforehand a defined contribution plan or a PERCO for all employees (since November 2010)
• The employer has an obligation to pay a predetermined amount of pension, only if the executive retires from the company or the group.
• The plan is financed by the employer only.
• Since 2010, the employer has to subscribe to an insurance policy to finance the plan.
PERCO

• **Collective but optional savings system** which benefits all employees in order to complete their mandatory pensions

• The employees can transfer the amounts of their optional profit sharing plan ("intérressement") and their mandatory profit sharing plan ("participation")

• They constitute funds in anticipation of their retirement

• The employer can complete the amount transferred by the employee

• The PERCO is managed by banks and the employees could have a lump sum or a pension. If they choose a pension, it is paid by an insurance company.
Tax and social contributions incentives

• To incentivize companies to set up supplementary pension plans, the government has reduced the social contributions and the taxes.

• In order to obtain these tax and social contribution cuts, the companies have to meet the requirements mentioned previously (collective system, management by an insurance company or a bank).

• This specific system was created in order to give benefits to a large number of employees. The management by third-parties was done in order to limit insolvency and bankruptcy risks.
In conclusion: some figures
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Mandatory pension’s decrease

<table>
<thead>
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<th>Group</th>
<th>2000</th>
<th>2020</th>
<th>2040</th>
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</thead>
<tbody>
<tr>
<td>Workers</td>
<td>84%</td>
<td>71%</td>
<td>67%</td>
</tr>
<tr>
<td>Middle management</td>
<td>75%</td>
<td>62%</td>
<td>58%</td>
</tr>
<tr>
<td>Executives</td>
<td>56%</td>
<td>50%</td>
<td>47%</td>
</tr>
</tbody>
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% of the last earned income during retirement
In conclusion: the future of retirement

• Increasing strain on the mandatory retirement systems
• New reforms have been announced by the government and more will follow in 2019
• A bright future for the supplementary pension plans
• Questions

• Thanks for your attention