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AMERICAN BAR ASSOCIATION

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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

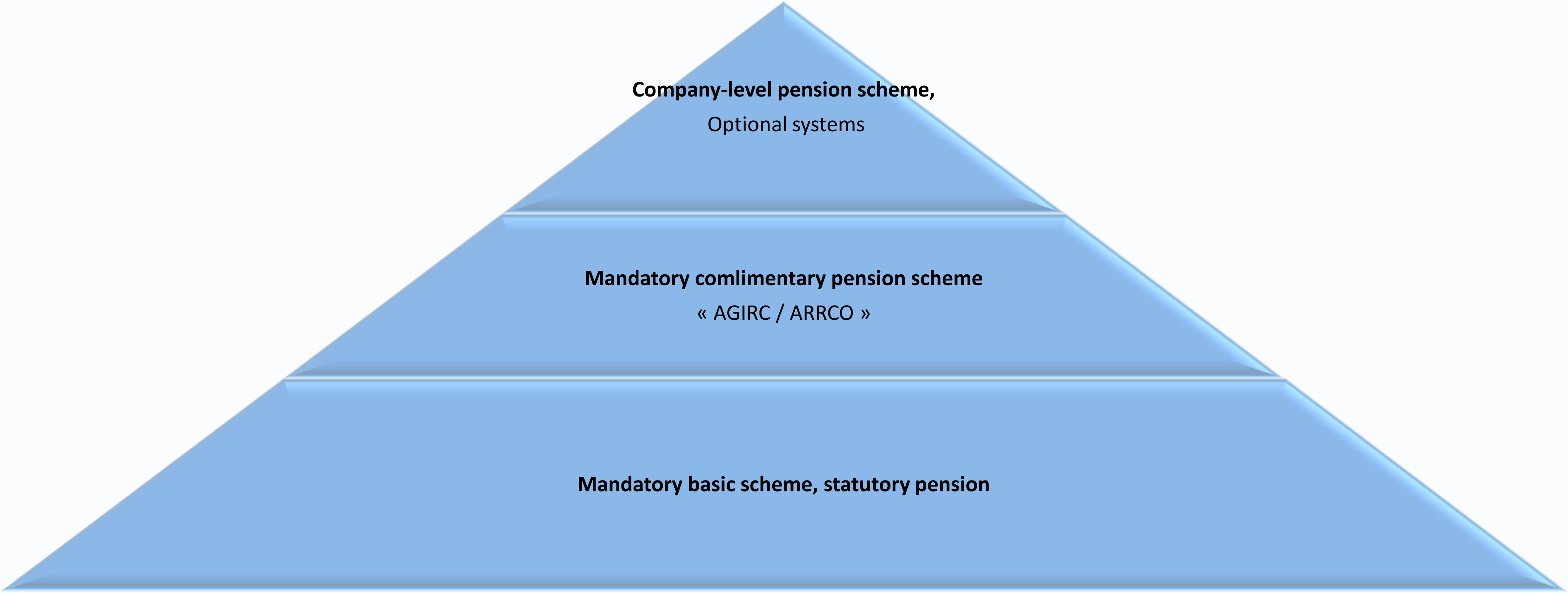
- Dodd Frank
- Proposed Clawback Rules
- Trump Regulatory Freeze

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



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

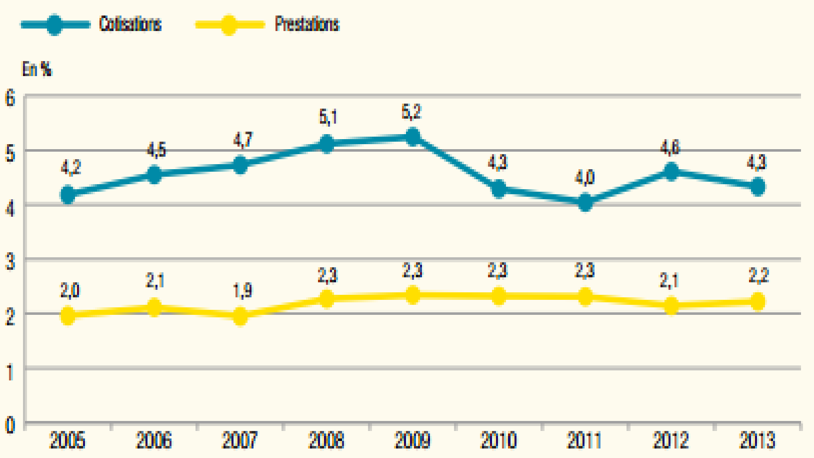
Prestations versées au titre de la retraite (en milliards d’euros)

Sources : DREES et estimations AFA pour 2014

	2010	2011	2012	2013	2014
Régimes obligatoires[1]	264,5	274,0	284,7	292,4	301,0
– Régimes de base	*191,7*	*200,1*	*205,7*	*211,9*	*219,0*
– Régimes complémentaires	*72,8*	*73,9*	*79,0*	*80,4*	*82,0*
Organismes d’assurances[2]	6,3	6,5	6,2	6,7	7,0
Ensemble	270,8	280,5	290,9	299,1	308,0

(1) Pensions de retraite versées au titre des droits directs et dérivés, ainsi que les avantages non contributifs comme le minimum vieillesse
(2) Sociétés d’assurances, mutuelles, institutions de prévoyance et organismes gestionnaires de Perco (hors prestations des contrats d’indemnités de fin de carrière, y compris transferts de contrats entre sociétés et rentes en versement forfaitaire unique)

Part de la retraite supplémentaire dans l’ensemble des régimes de retraite obligatoires et facultatifs



Supplementary retirement system: setting

Company Subscriber

Employer

Insurance

policy

Insurer

Suplementary Scheme

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

Works council

- information , consultation

Employees

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.

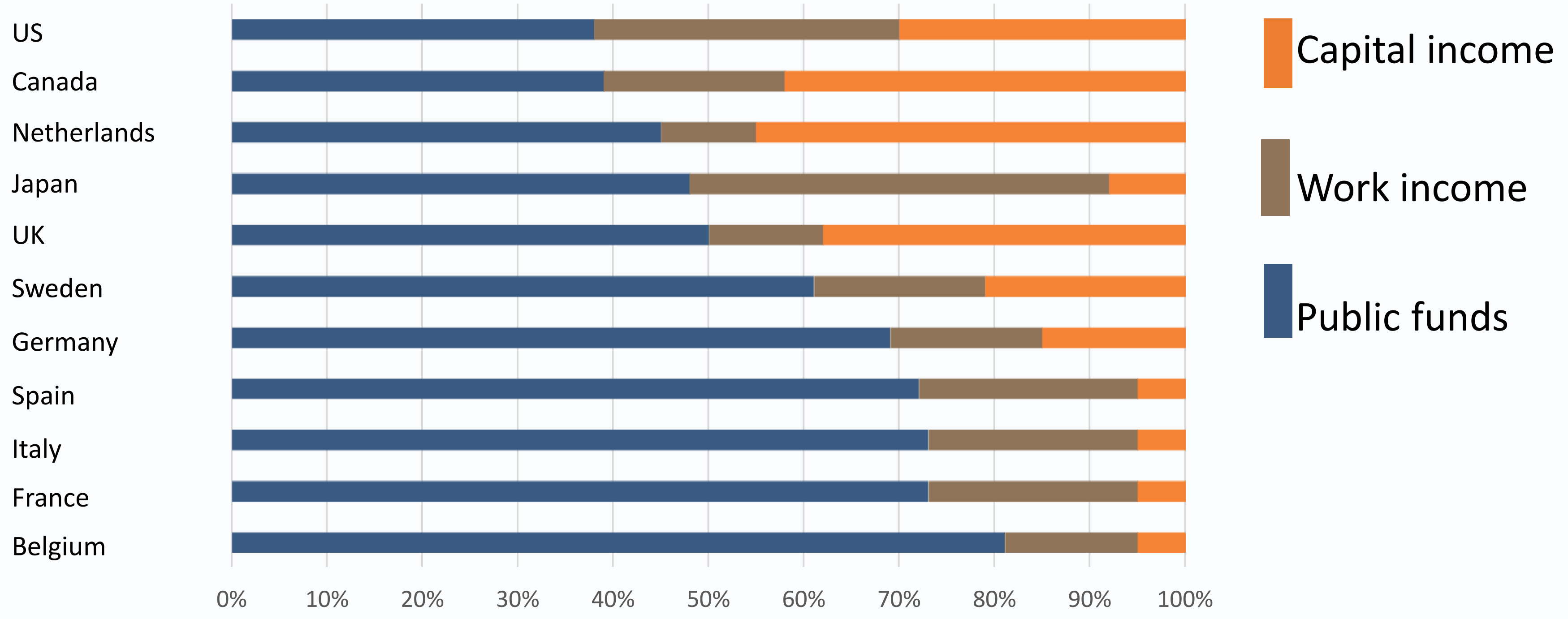
PERCO

- <u>**Collective but optional savings system**</u> which benefits all employees in order to complete their mandatory pensions
- The employees can transfer the amounts of their optional profit sharing plan (“intéressement”) 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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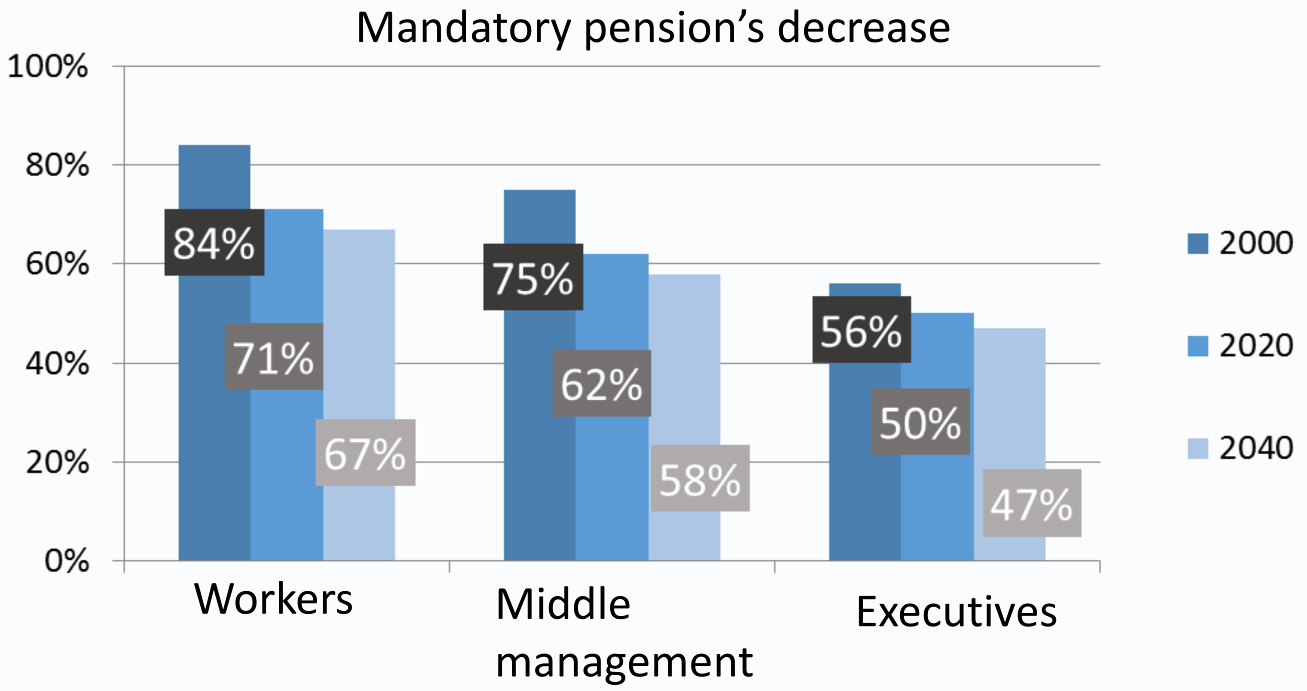

% of the last earned income during retirement

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