

EMPLOYMENT LAW CONFERENCE—2011 (DAY 2)

PAPER 3.1

Pension, Employment Benefit and Executive Compensation Strategies on Termination of Employment

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PENSION, EMPLOYMENT BENEFIT AND EXECUTIVE COMPENSATION STRATEGIES ON TERMINATION OF EMPLOYMENT

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I. Introduction

This paper is intended to canvas pension, employment benefit, and executive compensation strategies that employment counsel should consider at termination of employment, particularly in the context of more senior management employees. The content of this paper is intended to assist employment counsel in British Columbia, whether the client is the employer or the individual executive employee.

The treatment of registered pension plans, retiring allowances and deferred compensation arrangements, to name a few, at the time of termination can have significant monetary implications for both employees and employers. This paper will canvas some examples of best practices in advance planning for this crucial yet commonly overlooked area of the employment relationship. Specifically, the paper will address the following issues:

- Understanding Your Plan: Registered Pension Plans (“RPP”) versus Non-Registered Pension Plans, deferred compensation and stock purchase plans;
- Technical Matters: Issues such as the funding status of plans, historical plan design, and contractual agreements that may impact the settlement of obligations post termination;
- Employment Benefits: Balancing the interest of employers and employees can result in mutual satisfaction by bridging, settling, or transferring coverage; and
- Exit Plans: The importance of structuring voluntary or involuntary terminations to ensure optimal payout periods and tax treatment.

II. Overview of Plans Commonly Provided to Senior Employees

A. Registered Pension Plans

Besides the obvious determination of the amount of notice to provide the employee when the decision is made to terminate their services, significant cost implications can arise from decisions regarding the employee's continued accrual of pensions under the pension plan. The most obvious question is to determine what kind of pension plan the employer provides.

Employment pension plans covering private sector British Columbia employees are regulated by the *Pension Benefits Standards Act*, RSBC 1996, c 352. If the employer's business is federally regulated, then the *Pension Benefits Standards Act, 1985*, RSC 1985, c 32 applies. Both statutes protect plan members by providing minimum standards for eligibility, vesting, portability, survivor benefits, employer contributions and ongoing disclosures of plan terms and conditions to members.

Registered Pension Plans include defined benefit ("DB") plans, which promise a specific monthly income at retirement based on factors such as the employee's earnings and years of employment, and defined contribution ("DC") plans, which are based on contributions by the employer, and usually the employee, into an account to earn tax-deferred investment income. It is common that senior employees will enjoy a higher DC formula than other plan members. Unlike the DB plan, there is no defined promise of a specified monthly income. Increasingly, we are seeing pension plans based on a hybrid design offering both DB and DC benefits. It is important for any employment lawyer to recognize what kind of plan the employer provides and the extent to which terminating the employee will trigger (or curtail) entitlements under either the DB, DC, or hybrid structure. Planning strategies discussed later in this paper will address this in more detail.

One other important consideration when reviewing the employer's RPP is to determine whether the DB plan is fully funded. If the employer's pension plan is in a solvency deficiency position¹ at the time the decision is made to terminate the employee, this may impact the extent to which the employee will be entitled to receive their full entitlement or commuted value of the pension if it is determined that the employee wishes to transfer their full entitlement under the DB plan to their respective Registered Retirement Savings Plan ("RRSP") or other registered vehicle.

Moreover, *Income Tax Act*, RSC 1985, c 1 ("ITA") considerations need to be taken into account as the ITA dictates the extent to which the employee's commuted value within the plan can be transferred on a tax-sheltered basis and which portion will be subject to tax.² It is very important to consider whether the employee at termination is able to transfer the full commuted value of their RPP entitlements and, if not, what the tax considerations are for doing so. Given that the ITA restricts the amount of assets that may be transferred from a RPP to the individual on a lump sum basis, termination of an executive and transfer of their commuted value may have a negative tax consequence that needs to be taken into consideration in the overall termination package.

There are other historical plan design and governance considerations that need to be taken into account when terminating an employee. There has been a significant trend in Canada to convert DB plans to DC plans. This trend has resulted in a recent increase in litigation by employees who are alleging that the conversion from a DB to a DC arrangement has negatively impacted the promises

1 A "solvency deficiency" is the amount by which the assets in a DB plan are less than the solvency liabilities.

2 Subsection 147.3(4) of the ITA restricts the amount that may be transferred on a tax-free basis from a DB provision of a RPP to an RRSP or to a DC provision of a RPP. Income Tax Regulation 8517 provides the formula for determining the maximum transfer amount. It is important for employment counsel to keep the maximum transfer value rule in mind upon termination of a senior employee, as otherwise the employee could be subject to unintended tax consequences.

that were made to them when they were hired. In other words, was the DB to DC conversion handled properly and has the individual employee in question suffered any financial loss as a result of the conversion?³

In this same vein, it is important to consider whether or not the employee was promised anything at the date of hire for future pension accrual, distinct from other employees. It is common practice, particularly for employers with traditional DB plans, to have promised an enhancement to mid-career hires that will either match prior employer RPP entitlements or protect them from any impact of transferring from a predecessor employer to their current employer on some past service or future service enhancement basis. It is not uncommon to see such promises either within the employment contract itself or a reference to a schedule in the pension plan that identifies one or more executives, or class of executives, where a recognition of past service with their predecessor employer is provided. In essence, such executives may form part of a separate and distinct class of employees with an enhanced pension benefit.

Such side arrangements are not as easily settled as what might first appear given changing income tax and pension legislative considerations. This is particularly the case if between the date of hire for the employee and the date at which a determination is made to terminate them, plan design changes have occurred that make the original pension enhancement promise untenable from a cost and tax compliance perspective. Conversely, given the flexibility of DB plans to grant past service accruals, there are methods and strategies that could be employed to provide enhancements to the pension accrual as a means to offset any negative consequences inherent in terminating an employee before they have become entitled to either early retirement subsidies within the plan or entitlements to a supplemental pension payment.

It is generally understood that the establishment of a RPP is not intended to expand or confer any employment rights on the members of the plan; however, liability for damages for breach of contract has been held by Canadian courts to include damages for lost pension benefits accruing during the notice period.⁴

B. Supplemental Pension Plans

Supplemental employee retirement plans (or “SERPs”) are very common amongst senior (and many middle manager) employees. A supplemental pension plan is, as the name suggests, designed to provide additional pension accrual and benefit payments to employees who, due to their higher earnings, will have reached the maximum pension limit accrual under the ITA.⁵ The SERP is designed to provide higher income employees with a pension that essentially works around the ITA maximum pension rules while mirroring the terms of the RPP.

It is important for employment counsel to consider whether the employer, in fact, provides a SERP and if so, what the terms of the payment under the plan are. Important terms to consider are whether the plan is a fully funded arrangement, secured by a letter of credit, or a combination of the two. Most

3 There are two recent B.C. actions involving plan conversions and plan sponsor liability arising from benefit levels post-conversion and member communications. While the parties in *Dawson v. Tolko Industries Ltd.* filed a Consent Order in March 2011 dismissing the action, and thus no court decision will be published, a case with similar claim involving breach of fiduciary duty and negligence, *James Weldon v. Teck Metals Ltd.*, is currently before the B.C. Supreme Court.

4 *Taggart v. Canada Life Assurance Co.* (2006), 2006 CarswellOnt 1141 (Ont. C.A.). See also, *Bardal v. Globe & Mail Ltd.* (1960), 24 K.L.R. (2d) 140 (Ont. H.C.).

5 ITA Reg 8504 limits the amount of benefits payable under a DB RPP. For this reason, SERPs are attractive as a supplement to DB plans. The ITA maximum pension rule does not apply to DC plans; however, there are limitations to the permissible annual contributions to DC plans. Accordingly, with the trend of conversions from DB to DC, SERPs for DC plans are becoming more common.

SERPs in Canada are, in fact, not funded and are provided strictly on a pay-as-you-go basis such that the employer's sole obligation is to provide funding and payments under the SERP at retirement. It is also important to consider whether or not the plan is funded and whether there are any defined events (such as early termination of employment or change of control provisions) that would trigger lump sum or accelerated payments under the SERP upon termination. Some of the most senior executives in this country have their own personalized SERPs that are carefully drafted to ensure that on any early termination of employment, significant payments are payable under the SERP. It is often the case that a SERP will represent several multiples of what the executive would receive under the RPP. Caution should be taken in considering how and when these amounts are paid and whether the amounts are payable in a lump sum or in a periodic fashion.

There are significant tax implications that must also be considered if and when the employee is terminated and has an entitlement under the SERP, particularly if the executive is a U.S. taxpayer or taxpayer in a foreign tax jurisdiction that does not recognize SERPs under the applicable tax treaties with Canada. In other words, benefits payable under the SERP can attract immediate taxation in the executive's home jurisdiction both during the period at which the pension plan may have been funded and when entitlements under the SERP vest and become payable due to termination of employment.⁶ Details of the cross border tax jurisdictional issues are beyond the scope of this paper. However, employment counsel should seek clarification if the executive meets these characteristics and the SERP is sufficiently large to trigger exit tax.⁷

When considering whether the executive has or is entitled to receive supplemental pension benefits on termination of employment, one question to ask the employer is whether or not the plan is funded either with cash or secured via a letter of credit. Letters of credit are normally triggered upon failure of a plan sponsor to pay supplemental pensions when they are due or failure to renew the letter of credit on an annual basis. If the plan is funded or secured with a letter of credit, the SERP will be deemed to be a Retirement Compensation Arrangement ("RCA") under the ITA.⁸

C. Retirement Compensation Arrangements

A properly constituted RCA allows an employer to make contributions to be held in trust, or to secure promised benefits with a letter of credit, with the intention of distributing benefits to eligible employees after the employee terminates employment, retires, or dies. One particular advantage of an RCA is that while the employee remains employed, there is no tax payable on the benefits accruing to the employee.⁹ Once an employee meets the terms for qualifying payment under the RCA (i.e. ceases employment) and begins receiving benefits, the amount of the benefit is included in the employee's

6 See article XVIII of the Canada-United States Tax Convention (1980). For example, unlike Canada where employers are permitted to contribute to a SERP, or secure the promise via a Retirement Compensation Arrangement trust, without tax implications to the individual employee until termination, the US does not recognize such arrangements and will tax the employee on a current basis for all contributions made in the year and any earnings thereon.

7 We use the term "exit tax" to indicate where there may be tax implications when a non-Canadian senior employee returns to his/her home country. For example, the withholding tax payable on employment related income of 25% of the amount may or may not be recognized when the employee repatriates his/her pension assets.

8 Subsection 248(1) ITA defines an arrangement under which contributions by an employer or former employer may be made to a custodian in connection with benefits that are to be or may be received on or after retirement or termination of employment.

9 But recall if the employee is a US taxpayer, the Internal Revenue Code looks through the RCA trust and taxes the contributions and earnings on an annual basis. Some of this tax can be offset through foreign tax credits between Canada and the US.

income and attracts full marginal tax rates. Again, careful planning is required upon termination of an employee who has an entitlement under a RCA.¹⁰

D. Retiring Allowances

An often over-looked planning strategy when terminating a senior executive who has had long service with the employer is the use of a retiring allowance (“RA”) as a settlement mechanism for part or all of the salary in lieu of notice. The ITA permits an employer to pay an amount to an employee on or after retirement from office or employment in recognition of long service or in respect of a loss of office or employment.¹¹ RAs allow employers to structure settlements or recognize past long service of the employee in such a way that might otherwise be paid as a lump sum and subject to immediate taxation. Moreover, RAs can be structured for payment over several years as well as allowing portions of that amount to be transferred to the individual’s RRSP and thus sheltering some of this otherwise taxable employment income.¹²

It may be the case that on a termination of a senior executive, promises were made at the date of hire or during their career that certain top-ups to their pension would be made or that profit sharing would be distributed when, in fact, over the years these promises were never fulfilled. Again, it is important to consider what promises were made and what employment contracts specified regarding retirement savings and profit sharing objectives. Often promises are made that were simply not documented properly or at all. A properly structured RA agreement can provide both the employer and the terminating employee with significant advantages from a tax and cost perspective. Although most employers wish to sever the ties with the senior executive as soon as possible, if the quantum of settlement whether in lieu of pay, or, the need to recognize prior promises, or simply to settle on some amicable basis what the parties have determined is owing to the executive, payment of a RA can be structured such that it is made over a periodic basis perhaps for as many as ten years.

RAs can also be structured to address consideration for post employment non-solicitation and competition provisions that may or may not exist in the employment contract. Again, there are myriad of fact patterns and situations that will dictate how and when to use a retiring allowance but its use as a tool for settlement of monies owing to senior executives should not be overlooked.

Notwithstanding the attractiveness of a RA to structure settlement monies owing to an executive on termination, RAs do not qualify as employment income for purposes of pension accrual. Therefore, to provide pension accrual during the notice period, consideration must be given to the timing of the termination date. RAs may not be “pensionable earnings” under the ITA. Parties should be careful to coordinate how and when to use a retiring allowance if it’s determined that the executive is entitled to pension accrual during the notice period.

10 From a practical perspective, employment counsel needs to consider timing issues involved in the windup of the RCA trust and obligations to comply with ITA withholding requirements. For example, on termination, immediate steps must be taken to distribute assets in the RCA trust to the employee before the employer is able to apply for the 50% refundable tax payable from the Receiver General. Therefore, realistic payout timing should be communicated to the employee and included in any release.

11 Subsection 248(1) defines a retiring allowance as an amount received by an employee “on or after retirement of a taxpayer from an office or employment in recognition of the taxpayer’s long service, or in respect of a loss of an office or employment of a taxpayer, whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal.” See also Income Tax Interpretation Bulletin IT-337R4 (Consolidated).

12 See subsection 60(j.1) which permits a taxpayer to defer income tax on an amount received on or after retirement by transferring a prescribed amount to a RPP or RRSP (See IT-337R4 for the prescribed amounts). If the employee has unused RRSP deduction room, RA amounts may be contributed to the RRSP or a spousal or common-law RRSP as long as there is room.

III. Other Deferred Compensation Considerations

Another area that requires careful review and planning when terminating a senior executive is to determine whether the employer provides any deferred compensation or other equity-based plans to their employees. Such long-term incentive plans (“LTIPs”) typically award equity-based compensation in the form of shares, stock options, or share equivalents. Many LTIPs contain specific provisions regarding acceleration of vesting (i.e. when the employee is entitled to receive the stock or exercise stock purchase option provisions), change of control provisions, and termination of employment prior to normal retirement. When reviewing these plans, one is often struck by the incongruity between the terms of these plans and what the employment contract stipulates. For instance, there are often differential interpretations of what “cause” versus “good reason” mean between the deferred compensation plan and the employment contract. Reconciliation of these different interpretations between these plans and the employment contracts can often be challenging. It is often the case that if the employer is sufficiently large, the parent company (often a U.S. public or private company) has used provisions that are in keeping U.S. tax and security law provisions but are not easily transferrable or enforceable under Canadian tax and employment laws.

Employment counsel should again be cautious when reviewing the termination of an executive who has any entitlement under LTIPs to ensure that a termination without cause (and even with cause) does not trigger entitlements that the company had not budgeted for under the terms of their LTIP. There are situations where an early termination of an executive will entitle that executive to exercise stock options or stock purchase rights and become a fairly significant shareholder in the employer corporation while at the same time terminated from employment. This ironic situation can often be avoided through careful planning prior to termination.

As mentioned above, one of the first issues to consider when terminating an executive is the tax jurisdiction of that employee and, in particular, whether they file taxes in the United States. Most deferred compensation plans in Canada will be subject to the long arm of the U.S. *Internal Revenue Code* and in particular Section 409A which restricts payment of a deferred compensation benefit to “key employees” for at least six months after termination of employment. Failure to comply with Section 409A rules will subject the employee to significant tax penalties and interest. Although this is an individual employee exposure, it is not difficult to imagine a situation where an executive employee seeks redress against the employer for taxes and penalties payable under Section 409A. Again, careful planning will be required in situations such as these. Advice of knowledgeable U.S. counsel is strongly advised.

IV. Employment Benefits

Another area that employment counsel should consider before terminating executives is the extent to which the loss of office will result in termination of their extended health and dental benefits, long-term disability, and life insurance. Employment benefits are often quite valuable, particularly to an older executive who may or may not qualify, due to pre-existing health problems, for such benefits post employment. The value of these benefits to an employee often require quantification to ensure that they are either extended through the notice period or their value is paid to the employee thus enabling them to purchase these benefits on an individual basis. Given that employee benefits are priced on a group basis, the cost of purchasing replacement insurance on an individual basis is significantly higher so a cost gross-up may be warranted. Most insurance companies are not willing to provide individual insurance to executives post employment without evidence of insurability. Therefore, it is important to ensure that the executive is advised of the rights of conversion of, in particular, life insurance and long term disability post employment. Conversion without evidence of insurability within 30 days of termination of employment is a standard provision. There are situations where insurance companies are willing to extend employee benefits during the notice period but again this should be reviewed on a case by case basis to ensure such extensions are available.

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There is case law that employment counsel are likely aware of involving the employer's failure to advise employees on termination of employment of their rights of conversion for life and long-term disability benefits.¹³ If, for instance, the executive would not qualify for life insurance or long-term disability coverage due to a medical condition that has arisen during his tenure with the employer, failure to convert this benefit within the conversion period can result in significant costs to the employer due to its failure to advise the employee of these conversion rights and the benefits of doing so. Communication of these issues is crucial.

V. Conclusion

As indicated in the introduction to this paper, our aim is to highlight key pension, employment benefit, and executive compensation strategies that employment counsel should consider on the termination of executive employees. There are, of course, a myriad of fact situations, pension plan structures, deferred compensation plans with their own often complex terms and conditions; however, the one common thread is that with proper review and understanding of these plans prior to termination of an executive, significant pitfalls can be avoided and, in fact, opportunities exploited that will benefit both the employer and the terminating employee. Ideally, the issues raised in this paper will be considered before the employee is hired, and decisions reflected in the contract of employment. A safe guideline is that the more senior the executive and the more sophisticated the employer organization, the greater the requirements for planning prior to terminating the executive.

Appendix 'A' is intended as a very high level list of questions employment counsel should ask themselves and their employer client when planning for a termination of a senior executive. This list is by no means exhaustive and is simply a guide for analysis and planning to ensure that the cost of terminating a senior executive is not underestimated before it is too late to structure the termination in a cost and tax efficient manner.

¹³ See, for example, *Lehune v. Kelowna (City)*, 1994 CarswellBC 469, 98 B.C.L.R. (2d) 135 (B.C.C.A.), where a court awarded damages against an employer for failing to advise an employee of life insurance conversion rights.

VI. Appendix A—Common Questions and Considerations on Termination of an Executive Employee

1. Does the employer provide a registered pension plan? If so, what is the nature of the plan (i.e. defined benefit (“DB”), defined contribution (“DC”), hybrid)?
2. If the plan is a DB plan, what is the funding status of the plan? If the plan has a solvency deficiency, what is the effect on the pension benefit available to the executive? Are there any strategies available to enhance the pension as an offset for other monies that may be owing in the settlement?
3. Has the plan undergone a conversion from DB to DC? If so, has the conversion resulted in a net loss or gain to the employee in total pensionable earnings?
4. Was the employee offered any pension enhancements at date of hire, or at any point prior to termination? Do such enhancements require special consideration on settlement?
5. If the answer to questions #3 and #4 are ‘yes’, is independent actuarial advice required?
6. Has the termination triggered any unanticipated gains or losses to the employee (loss of pension enhancement, early retirement, and any other benefits otherwise available at normal retirement)?
7. Does the employer provide a Supplemental Employee Retirement Plan (“SERP”)?
8. Is the employee a US taxpayer or a taxpayer in another country?
9. Is the SERP funded, secured by a letter of credit, or some combination of the two?
10. If the SERP is not funded or secured, how will the employer settle their obligations to provided promised benefits to the employee?
11. Is there any benefit in settling the SERP promise by way of lump-sum payment, or by way of periodic payments?
12. If the SERP is funded through a Retirement Compensation Arrangement (“RCA”), what are the timing implications of winding up the RCA trust (including RCA refundable tax), and have these timing implications been considered in preparing a release and communicating with the employee?
13. Has the employer provided a retiring allowance (“RA”) agreement to its executive employees?
14. Would a RA be an appropriate settlement mechanism for part or all of the payment in lieu of notice?
15. Would the parties be amenable to structuring a RA that is payable over many years post-employment.
16. Is the employee’s length of service with the employer sufficient to warrant a transfer of the retiring allowance to an RRSP and/or does the employee have RRSP room available that would enable tax sheltering some of the RA.
17. If the employee does not have an employment agreement that includes non-solicitation and non-competition provisions, would the RA be sufficient consideration to obtain such agreements?
18. Does the employer provide Long Term Incentive Plans (“LTIPs”)?
19. What rights does the LTIP grant to employees on vesting and termination of employment?
20. Do the provisions of the employment contract comply or conflict with the terms of the LTIP?
21. Would the termination of the employee create any undesirable stock or equity ownership issues post-employment?
22. Do any available employment benefits allow for the conversion from group to individual coverage on termination? And if so, has the employer communicated such options to the employee?

