June 3, 2010

Pensions Part 1 – Defined Benefit Plans

This article is the first part of a four-part series on employer retirement plans. Due to the complexity and variety of employer retirement plans, instead of one lengthy article, we have broken down the content into four separate articles: Defined Benefit (DB) Registered Pension Plans (RPPs), Defined Contribution (DC) RPPs, Deferred Profit Sharing Plans (DPSPs) and Group RRSPs. In all the articles, the term "pension plan" refers to an employer-sponsored retirement plan — not a government pension plan like Canada Pension Plan (CPP) or Quebec Pension Plan (QPP).

This article gives a detailed overview of how DB plans work, including formulas to help you calculate pension amounts and definitions and descriptions of different facets of DB plans.

A metaphor that is sometimes used for retirement planning is the three-legged stool – that is, your retirement income sources can be thought of as the legs of a three-legged stool. In order to have a financially secure retirement, all three legs of the stool should be sturdy enough to keep the stool upright. The three legs of the retirement income stool are:

- Government income sources (e.g., CPP/QPP and Old Age Security (OAS))
- Employer retirement plans or pensions
- Personal savings (RRSPs and non-registered savings)

(Note that in some cases, you may have adequate personal savings or an adequate employer pension to have a financially secure retirement even though one or two of the other legs are not significant contributors).

This series of articles is intended to provide you with information on the employer retirement plans leg of the retirement income stool.

Pensions Part 1

the ADVISOR

Due to the fact that pension legislation differs between the various provinces and that each pension plan has its own unique terms, there may be situations where the information in the articles will not apply to a specific employer retirement plan. Therefore, it is imperative that you consult your employer's pension administrator for final confirmation on any questions you may have on your own employer retirement plan.

Registered pension plans (RPPs)

A registered pension plan (RPP) is an employer-sponsored pension plan that has met certain registration requirements under the Income Tax Act. In general, if you are a member of an RPP, contributions to the plan by the employer and/or the employee (hereinafter referred to as the "member") are tax-deductible to the contributor and the income earned within the plan grows tax-deferred.

Furthermore, a feature that distinguishes an RPP from other tax-deferred retirement plans is that funds accumulating within the RPP on behalf of the individual member are generally locked-in under the relevant federal or provincial pension legislation.

There are two types of RPPs available: a DB Defined Benefit (DB) RPP and a DC Defined Contribution RPP. This article will discuss DB plans only.

A DB plan is one of the most popular types of RPPs. DB plans are generally offered to employees of governments and large public companies. As the name suggests, the amount of pension that the member will receive in retirement is generally "defined" or predetermined to be a fixed amount per year based on a formula.

In most cases, this fixed benefit under a DB plan is guaranteed to the member at retirement. However, under certain circumstances, it is possible that the amount of the actual DB pension in the future is smaller than the expected benefit due to the employer's inability to meet its pension obligations because of financial difficulties. This is discussed in more detail below in the section called "Employer difficulties and pension deficits."

Although there can be variations in the formula, the most common type of DB plan is based on either final average or best average earnings. In general, the annual pension under a DB plan is based on the following three factors:

- A percentage, generally up to 2%
- The member's years of service
- The member's earnings over a certain period of time

Example

Assume an employer has a DB plan with the following pension formula:

Annual pension = 2% x Years of service x Annual average of best consecutive 60 months of earnings

In this example, an employee who retires with 20 years of service and $60,000 as an annual average of their best consecutive 60 months of earnings will receive an annual pension of $24,000 per year for life [2% x 20 x $60,000].

Under the Income Tax Act, the maximum annual pension that an employee can receive from a DB registered pension plan is $2,494.44 x Years of service.

The reason for using $2,494.44 is that it is exactly one-ninth of the defined contribution or Money Purchase Plan annual contribution limit of $22,450 for 2010. The number "9" is important when it comes to comparing DB plans to DC plans; its significance is discussed in greater detail in the "Pension Adjustment" section.

The $2,494.44 per year limit is proposed to increase after 2010 according to increases in the average wage. If an employee begins receiving a pension in 2010, the maximum annual DB pension will be $2,494.44 per year of service. If the employee retires in 2010 and they are expected to be at the maximum DB pension limit, then their maximum pension limit of $2,494.44 per year of service will generally be applied to all years of service. However, the pension plan may have to be amended to allow for the higher DB limit for all years of service.

A question that is commonly asked is, if the maximum annual DB plan limit is $2,494.44 per year of service, how can an executive with 30 years of service (for example) receive an employer pension in retirement of $120,000 per year for life? According to the maximum annual DB pension plan limit, this employee's maximum DB pension should be only $74,833.20 per year ($2,494.44 x 30 years of service). The reason a higher pension is possible is the employer has likely set up a Supplemental Executive Retirement Plan (SERP) to "supplement" the $74,494.44 per year that this employee will receive from the regular DB plan. A typical SERP that major Canadian employers set up for their key executives is a Retirement Compensation Arrangement (RCA).

It is important to note that the SERP structure cannot be an RPP, which means that the investment income earned within a SERP cannot enjoy the same tax-deferred growth that is offered with the RPP or an RRSP.

Normal retirement date and early retirement date

DB plans typically have a normal retirement date (NRD) of age 65, but it could be earlier, age 60 for example. It is rare that the NRD of a DB plan is earlier than age 60. The NRD is generally the age at which the member can retire from the employer with no early retirement reduction or penalty to their pension. The early retirement date (ERD), on the other hand, refers to the earliest age at which a member can start receiving a monthly pension from the employer.

If a member starts receiving the DB pension prior to the NRD, then it is possible that their annual pension will be reduced by a certain percentage per year. The reason for the reduction is that by receiving a pension prior to the NRD, the pension will be payable for longer than if the member had continued working and waited until the NRD to start collecting their pension.

The early retirement penalty generally ranges from 2% to 6% per year prior to the NRD or prior to an age where there is no early retirement penalty. This reduced pension will remain reduced for life, similar to the way in which CPP/QPP is reduced for life if the member starts to collect CPP or QPP prior to age 65.

Note that some DB plans are structured so that even if a member retires prior to the NRD, their lifetime pension is not reduced by an early retirement penalty. This is generally the case if the member has achieved 30 or 35 years of service, or if their age plus service equals a certain number of points (e.g., 80, 85 or 90). The combination of age and service is sometimes referred to as a “factor” (e.g., the 80 factor, 85 factor or 90 factor).

The Ontario Teachers’ Pension Plan is an example of a large DB plan that has an age plus service factor (i.e., 85 factor) where the early retirement reduction will be waived if this factor is attained.

Phased retirement — partial pensions

Effective January 2008, a phased retirement is available to employees who are both at least age 55 and also eligible to receive an unreduced DB pension. This allows employers to offer a partial pension of up to 60%, including bridging benefits, which are described below to the employee while they continue to work and contribute to the DB pension plan. Before this new law was enacted, the Income Tax Act did not allow employees to accrue pension benefits if they also received a pension from their employer.

Integrated or bridged pensions

Some DB plans are integrated with CPP/QPP and/or OAS. This means that members who start receiving their pensions prior to age 65 will initially receive a higher benefit than they would with a non-integrated pension. However, when they reach age 65, their pension will be reduced by a specific amount due to the fact that CPP/QPP and/or OAS generally commence at age 65.

Note that the reduction at age 65 will not necessarily be the exact amount of CPP/QPP and/or OAS that you receive from the government. In many cases, the CPP/QPP and/or OAS benefit received from the government will be greater than the amount by which the DB plan is reduced at age 65.

The incremental increase in the pension received prior to age 65 is called a “bridge” benefit. If an employee retires prior to age 65, since their CPP/QPP and/or OAS has not begun yet, their employer will provide a higher pension before age 65 to help bridge the member to age 65 when they start receiving government pensions.

Furthermore, members who retire before age 65 and receive an integrated pension do not have to wait until age 65 to collect their CPP/QPP. This means it is generally possible for a retired individual or those earning low income to collect CPP/QPP as early as age 60 and continue to receive the higher integrated pension to age 65 at the same time. This is because the payment of the employer-integrated pension and the CPP/QPP are independent of each other.

Contributions

Employer contributions to a DB plan are mandatory. If the plan is “contributory,” then the member also makes contributions to the plan whereas, if the plan is “non-contributory,” the member does not contribute to the plan.

The maximum amount a member can contribute to a DB plan for each year of current service is the lesser of two amounts:

- 9% of the member's compensation for the current year, and
- $1,000 plus 70% of the member's pension credit for the current year.

The "pension credit" is similar to a Pension Adjustment (PA) with some minor differences. The PA is explained in the "Pension adjustment" section.

Alternatively, the annual deductible contributions that an employer needs to make to a DB plan are determined by a licensed actuary (see the "Actuarial involvement" section for more information).

Contribution holiday

When the assets in a DB plan exceed its liabilities, the difference is considered to be a pension surplus. In certain cases, employers may be permitted to suspend contributions to the DB plan due to the amount of the pension surplus. This suspension of employer contributions is called a "contribution holiday."

However, even though the employer is not making contributions to the DB plan due to a contribution holiday, the member will continue to accrue a pension benefit for that year. Consequently, a PA will still be reported for the member. In some cases, a contribution holiday that is enjoyed by an employer can also be extended to the employees, reducing the level of member contributions to a contributory plan.

The employer invests the contributions made by the employer and the member. The members are generally not involved in determining how the pension funds are invested. The qualified investments within a DB plan are similar to those permitted in an RRSP or RRIF with additional restrictions set by the applicable federal or provincial legislation. For example, Schedule III of the federal Pension Benefits Standards Regulations, which has also been adopted by many provinces, states that a pension fund cannot invest more than 10% of the book value of the plan assets in any one bond or share of a corporation.

This is obviously different from the rules relating to an RRSP or RRIF where it is possible that 100% of the plan assets can be invested in one domestic content qualified investment without any penalties.

Tax implications

Employer contributions to a DB plan are deductible to the employer and are not considered to be a taxable benefit to the member. Alternatively, contributions to a DB plan made by the member are deductible to the member and appear in box 20 of the member's T4 slip. The amount in box 20 of the T4 slip can be treated as a deduction on the member's federal income tax return.

Pension adjustment

When a member is accruing an annual pension benefit under a tax-sheltered retirement plan, for example, an RPP or a DPSP, the employer is required to calculate a PA and report this in box 52 of the member's T4 slip.

The member then reports the amount of the PA on their federal income tax return. The PA reduces the member's RRSP deduction limit for the following year.

PA reporting began in 1990. The objective was to attempt to equalize the tax-deferred retirement benefits individuals receive whether or not they are a member of a tax-deferred company retirement plan.

Example

Assume Mr. Jones and Mrs. Smith have the same earned income of $50,000. However, Mr. Jones is a member of a DB plan, whereas Mrs. Smith is self-employed and is not a member of a company pension plan. As Mr. Jones is a member of a DB plan, he is accruing benefits for himself in a tax-deferred retirement plan. However, as Mrs. Smith is not a member of a company retirement plan, her main source of saving in a tax-deferred retirement vehicle is through a personal RRSP. To allow both Mr. Jones and Mrs. Smith to accumulate annual tax-deferred retirement savings of similar amounts, Mr. Jones' employer reports a PA for the pension benefit that he is accruing in the DB plan. The PA reduces the amount of contributions that Mr. Jones can make to a personal RRSP for the following year. In contrast, Mrs. Smith receives no PA. This allows her to make a greater RRSP contribution than Mr. Jones can in order to help her make up for not being a member of a company tax-deferred retirement plan.

Pension adjustment formula

The formula for calculating the PA for a DB plan is as follows:

9 x benefit entitlement – $600

Benefit entitlement = the value of the DB pension for one year of service based on the plan formula

Example

Assume the DB plan formula is 2% x Years of service x Annual average of best consecutive 60 months of earnings. In this case, the PA for a DB plan member with $50,000 of earnings would be calculated as follows:

PA = 9 x (2% x 1 year of service x $50,000) – $600
= $8,400

PA assumptions and the number "9"

The reason for the number "9" in the DB plan PA formula is that based on certain actuarial assumptions, it has been estimated that $9 of contributions per year to a DB plan during one's working career will produce an annual pension of $1 for life. Some of the assumptions used to arrive at the number "9" are that the employee retires at age 63 with an unreduced pension after 35 years of plan membership and that the pension is indexed at 1% per year. Of course, as these assumptions don't apply to all pension plan members, there may be some inequities with the PA calculation.

In general, a DB plan PA for a given year tends to be over-estimated for younger employees so these employees may have a smaller RRSP deduction limit for the following year. This is one of the reasons why, given a choice, younger employees tend to prefer DC plans over DB plans. However, given a choice between participating in a DB plan or a DC plan, the decision should be based on other factors as well, such as risk tolerance, investment knowledge, survivor benefits and portability of accrued pension, to name a few, not just PA reporting.

Actuarial involvement

Due to the complexity of determining the amount that employers need to contribute to a DB plan today in order to have enough money in the pension to fund a fixed benefit to both current and future retirees, employers use the services of licensed pension actuaries. The pension actuary has undergone rigorous training and uses statistical calculations to determine the current funding required by the employer and member (if contributory) to pay the benefits promised in the pension plan. The actuary's job can be thought of as minimizing the risk that the pension fund will not have adequate monies to pay the promised benefits.

The calculations that pension actuaries perform are complex and involve the following factors:

- Life expectancies
- Retirement age
- Early terminations
- Investment returns
- Pension plan formula
- Probability of disability
- Probability of termination
- Earning levels of members
- Inflation
- Survivor benefits

Actuaries are generally called upon a minimum of every three years to prepare an up-to-date actuarial valuation in accordance with generally accepted actuarial principles. In fact, in order for the employer contribution to the pension plan to be deductible to the employer, the effective date of the actuarial valuation cannot be more than four years before the day on which the employer contribution is made.

The most recent actuarial valuation generally states how much an employer should be contributing to the DB plan annually for the next three years based on the pension fund assets that have accumulated to date and on the pension plan liabilities.

Options at termination or retirement

An employee is generally vested in a DB plan after the completion of two years of plan membership. In some cases, if the member had pensionable service prior to 1987, then they are fully vested for their pre-1987 service if they are at least 45 years old and have 10 years of service upon termination.

Vesting means that if the member terminates their DB plan membership, they are entitled to receive 100% of the DB pension that has accumulated to date on their behalf. However, if the member is not vested upon termination, only the contributions made by the employee plus interest can be taken in cash. The contributions plus interest are subject to tax at marginal tax rates. Alternatively, the member's contributions plus interest can be transferred on a tax-deferred basis to a non locked-in RRSP without affecting the member's unused RRSP deduction limit. However, please note that it must be the member's own RRSP, not an RRSP of which their spouse is the annuitant.

If a DB plan member is fully vested, they generally have the following options:

- Receive the DB pension from the employer commencing as early as their ERD
- Transfer the commuted value of the DB pension to a new employer's pension plan if the new employer is willing to accept the transfer
- Transfer the commuted value of the DB pension to an insurance company to purchase a life annuity
- Transfer the commuted value of the DB pension to a locked-in RRSP (LIRA), LIF, LRIF (only in certain provinces) or PRIF (only in Saskatchewan) at their own financial institution for self-directed investment management

It is possible that upon termination or retirement, the only option available for the member with the vested DB plan funds is to leave the DB pension with the employer. Some pension plans state that if an employee terminates within 10 years of their NRD (typically age 65), they are not permitted to transfer the commuted value of their DB pension out of the employer plan to a locked-in RRSP (or LIRA). Other pension plans may state that if an employee reaches a number of years of service or the age plus service factor, then they must collect a pension from the employer in retirement.

If you are a member of a DB plan, you may wish to check the terms of your own DB plan regarding your options upon termination if your DB funds are vested. For more information on locked-in RRSPs (LIRAs), LIFs, LRIFs and PRIFs and factors to consider in making the best decision, speak to your advisor.

Calculation of commuted value

How is the lump-sum commuted value calculated for a DB plan upon termination? It is the present-value calculation of all future annual payments if the pension is left with the employer. Only an actuary can perform this calculation using the discount rate provided by the Canadian Institute of Actuaries, based on the month of termination.

Regulation 8517 of the Income Tax Regulations limits the amount of the commuted value that can be transferred to a locked-in RRSP (LIRA) on a tax-deferred basis. This is common for teachers terminating from the Ontario Teachers' Pension Plan. That means that some of the commuted value may have to be paid in cash to the employee and is immediately taxable. If the employee has adequate unused RRSP deduction room, then some or all of the taxable cash payment may be sheltered from taxation. However, if the commuted value is transferred to another employer's DB plan and the new employer is willing to accept the full commuted value, then all the commuted value can be transferred to the new DB plan on a tax-deferred basis.

50% rule

In certain provinces, no more than 50% of the member's contributions plus interest after a certain date (generally December 31, 1986, but may vary by the province) can account for the lump sum commuted value upon termination. If the member's contributions plus interest after a certain date exceed 50% of the commuted value, then the excess is paid to the member in cash and is taxable. Alternatively, if the limits under Regulation 8517 have not been exceeded, then it may be possible to transfer the excess on a tax-deferred basis to the member's own non-locked-in RRSP or RRIF without requiring the unused RRSP deduction room.

Pension adjustment reversal

Upon termination of a DB plan, if a member transfers the commuted value to a locked-in RRSP (LIRA) or a new employer's RPP, the member may receive a pension adjustment reversal (PAR). The PAR is simply an increase in the member's unused RRSP deduction limit in the year of termination from the DB plan.

The concept of the PAR was introduced in the 1997 federal budget in an effort to provide fair treatment to those who had left pension plans and received far less from those plans than the amount by which their RRSP contribution limits were reduced as a result of previous PAs.

For every year since 1990, an employee who is a member of a DB plan receives a PA, which means that the member's RRSP deduction limit for the following year is reduced. However, since the PA calculation does not factor in a member's age or current interest rates, it is possible that the PA calculation will be high for certain years. If the commuted value received upon termination (related only to post-1989 service) is less than the sum of all the PAs reported for the member since 1990, a PAR is generated.

It is then the employer's responsibility to report the amount of the PAR to the CRA and to the member on a T10 slip. The member does not have to do anything; although, they may want to remind the employer of their responsibility to calculate the PAR. The PAR allows the member to recover RRSP deduction room that is lost due to the amount of the PA in excess of the post-1989 commuted value.

Note that the member will not receive a PAR if they decide to leave their accrued DB pension intact and collect a pension from the employer.

Also, it is not necessary to terminate employment to receive a PAR. When some employers convert their DB plan to a DC plan, the commuted value of the DB plan may be transferred to the DC plan. In this case, it is possible to receive a PAR even though the member has not terminated employment. The amount of the PAR, if any, will appear on the member's RRSP statement on their Notice of Assessment as an increase to their regular RRSP deduction limit. As a result, an RRSP contribution based on the PAR increase can be made to the member's RRSP or to a spousal RRSP, or can be carried forward.

Survivor benefits

In the case of a DB plan, the survivor benefits generally depend on who the beneficiary is and whether the member dies before collecting a pension or while they are collecting the pension.

Furthermore, under the relevant provincial or federal legislation, the spouse (including opposite- and same-sex common-law partners) is always first in line to receive the deceased member's survivor benefits, unless that right is waived by the surviving spouse or common-law partner. Note that the definition of common-law partner under provincial pension legislation is generally different than the definition in the Income Tax Act.

Member death before receipt of pension

If a member is fully vested upon death, the surviving spouse generally has the option to receive a fixed pension from the employer or to roll over the lump-sum commuted value of the DB plan to their own RRSP/RRIF (may be locked-in depending on the relevant jurisdiction). The fixed pension and commuted value that a surviving spouse receives may be less than the amount the member would have received.

If a minor child or minor grandchild is the beneficiary of the DB plan, then upon the death of the plan member, any survivor benefits paid out can be used to purchase a term insurance policy to age 18 annuity for the child or grandchild to avoid immediate taxation. Furthermore, if the child or grandchild (of any age) is mentally or physically infirm, the DB plan funds can be rolled over on a tax-deferred basis to the disabled child's or grandchild's non-locked-in RRSP or RRIF, or be used to purchase a life annuity.

If none of these situations apply, then the DB plan funds are fully taxable to the surviving beneficiary.

Member death while collecting pension

When an employee retires and decides to leave their DB pension with the employer, they are generally given a number of survivor benefit options for their pension. In general, there is a minimum survivor pension that the spouse must receive unless they waive their entitlement. The minimum spousal pension will vary between provinces. However, a surviving spouse is generally eligible to receive 50% to 66.7% of the monthly pension that the member was receiving immediately before their death.

However, in some cases it is possible for the surviving spouse to receive a pension equal to 100% of the deceased member's pension. In this case, due to the higher spousal benefit, the member spouse would receive an actuarially reduced monthly pension during their lifetime. Where the surviving spouse receives a pension for the rest of their life (albeit reduced in some cases), this survivor benefit feature is called a "joint and last survivor" pension.

Generally, if the surviving spouse is not permitted to receive a lump-sum commuted value because the member had already started collecting their pension from the employer, on the death of the surviving spouse, there may be a residual benefit paid to any remaining survivors if there is a guarantee period.

Guarantee period

A guarantee period is an option that may be chosen upon retirement to ensure that your survivors receive 100% of your annual pension for a certain number of years after you start collecting your pension. A typical guarantee period is five years, but can be longer.

If the member dies within five years of commencing their pension, the surviving beneficiary will continue to receive 100% of the member's pension until the end of the five-year period. After the five years have elapsed, the surviving beneficiary may continue to receive a survivor pension (which may be reduced) depending on whether the survivor is a spouse or a dependent child.

If the member does not have a spouse, then the survivor benefits that the surviving beneficiary will receive depend on the plan. In some cases, there are no survivor benefits at all if there is no surviving spouse. In other cases, if there are minor children or adult children in school, they may be eligible to receive a pension until they are no longer minor or no longer in school. In many cases, regardless of who the surviving beneficiary is, if the member received pension payments during their lifetime that did not exceed their contributions to the DB plan plus interest, then the excess contributions plus interest are refunded to the estate.

Pension surplus

There is some debate as to who owns any pension surplus in a DB plan. An employer may argue that as it bears the risk of the fixed DB pension promise to its members and is required to fund any deficits out of its own cash flow, it should also enjoy any surplus that is generated due to better-than-expected investment returns. Conversely, employees argue that a pension plan is set up for their benefit, and therefore, it's the employees who should enjoy any surplus.

In general, while a pension plan is ongoing, pension plan surpluses in certain cases can be used to subsidize current employer contributions or sometimes member contributions. In certain cases, a pension surplus within an ongoing plan can be unlocked and distributed in cash to members and pensioners if the surplus distribution is approved by the provincial or federal regulatory body.

If a pension surplus distribution to a member represents a refund of pre-1991 member contributions, then this portion of the surplus distribution can be transferred to the member's own RRSP or even RRIF on a tax-deferred basis without affecting their unused RRSP deduction limit.

Debates regarding pension surplus ownership generally occur when a pension plan is going through a partial or full wind up. There may be wording in the pension plan text as to who is entitled to any pension surplus – the employer or the members. Alternatively, a surplus can be shared between the employer and the members. However, many older pension plans lack clear wording regarding surplus ownership and consequently, courts become involved to assist in determining who is entitled to the surplus.

Employer difficulties and pension deficits

If the investments in the pension fund have not performed well since the last actuarial valuation and the plan liabilities have not substantially decreased, it's possible for the pension plan to go into a deficit.

A plan deficit generally means that the employer has to make a greater cash flow commitment to the DB plan over the next three years than originally expected. For the purpose of determining the required employer contributions, many DB plans in Canada have a valuation rate of interest ranging from 6% to 7.5% per year. Therefore, if the DB plan investments performed at less than the valuation rate of interest since the last actuarial valuation, the employer may be required to make greater contributions to the DB plan until the next actuarial valuation.

Employees of companies experiencing financial difficulties often ask if their pension will be affected if the company goes bankrupt. In most cases, the pension that has accrued to date is not affected as pension funds are generally not considered an asset of the company. Federal and provincial pension legislation provides that creditors of the employer cannot seize the accumulated pension funds. However, if a company goes bankrupt at a time when there is a pension deficit and the company has insufficient funds to make up the pension deficit, then the current members and possibly even existing pensioners may see a reduction in their promised DB pension.

The province of Ontario is the only province in Canada that has a Pension Benefits Guarantee Fund (PBGF). The PBGF is a form of insurance funded by employers that have pensions governed by Ontario pension legislation. If an employer governed by Ontario pension legislation has financial difficulty making the required DB pension payments, the troubled employer can access the PBGF — within limits — for help in meeting its pension obligations.