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FINANCIAL ADVISORY SUPPORT

Pensions Part 2 – Defined Contribution Plans

This article is the second 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 the content into four separate articles: Defined Benefit (DB) Registered Pension Plans, Defined Contribution (DC) Registered Pension Plans, Deferred Profit Sharing Plans (DPSPs) and Group RRSPs. This article gives a detailed overview of how DC plans work, including formulas to help you calculate pension amounts and definitions and descriptions of different facets of DC plans.

In all the articles, the term "pension plan" refers to an employer-sponsored retirement plan — not a government pension plan like the Canada Pension Plan (CPP) or Quebec Pension Plan (QPP).

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.

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.

Registered Pension Plan (RPP)

A Registered Pension Plan (RPP) is an employer-sponsored pension plan that meets 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 "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 Defined Benefit RPP (or DB plan) and a Defined Contribution RPP (or DC plan). This article will discuss DC plans only.

How is a DC plan different from a DB plan?

- The retirement income that you can obtain from a DC plan is based on the investment earnings in the plan and is not fixed as it is in a DB plan, so the employer does not require the services of a licensed actuary. The employee bears the investment risk of a DC plan. It is generally less costly for an employer than a DB plan and easier to administer.

- Members of a DC plan generally choose the investments within their plan instead of the employer, which is the case with a DB plan. For this reason, many employers provide extensive communication and education on investments and asset allocation to assist plan members in choosing appropriate investments.

- DC plans are more common in the private sector. There has also been a trend in recent years of employers converting their DB plans to DC plans due to the costs and risk that the employer has to bear with DB plans.

How is a DC plan different from an RRSP/RRIF?

In the *Income Tax Act*, a DC plan is referred to as a Money Purchase Plan (MPP). It has some features that are similar to a regular RRSP or RRIF, but there are a number of differences as explained below:

- **The primary difference between a DC plan and an RRSP or RRIF is that the funds in a DC plan are generally locked-in under the applicable provincial pension legislation, whereas the funds in a regular RRSP or RRIF are not locked-in.**

- You can withdraw RRSP or RRIF funds at any time, but due to the locking-in feature of a DC plan, you generally cannot make withdrawals from a DC plan or a locked-in plan that originated from a DC plan until you reach a minimum age. This varies by province.

- There is generally a maximum annual withdrawal limit for funds held in a DC plan or a locked-in plan that originated from a DC Plan, whereas there is no maximum annual withdrawal limit for an RRSP or RRIF.

- Assets inside a DC plan or a locked-in plan that originated from a DC plan are protected from creditors under the relevant pension legislation. Assets within a non-locked-in RRSP or RRIF may be protected from creditors depending on the province where you live and the circumstances in question.

Although qualified investments within a DC plan are similar to those in an RRSP or RRIF, additional restrictions are 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 different from the rules relating to RRSPs and RRIFs, where it is possible for 100% of the plan assets to be invested in one qualified investment without any penalties.

Contributions

In a DC plan, the employer and sometimes the member can make contributions to the plan. The amount of contribution is generally based on a percentage of the member's compensation. The maximum contribution that can be made to a DC plan for 2010 is the lesser of $22,450 or 18% of the member's compensation for the current year.

As a general administrative rule, the CRA has stated that in a "stand-alone" DC plan (i.e., not a combination DB and DC plan), the employer must contribute at least 1% of each member's earnings, but not more than the maximum limit for that year.

It is not mandatory that members contribute to a DC plan unless it is required within a specific employer's DC plan. In some DC plans, the employer's contributions are made to the DC plan, but the member's contributions are made to a non-locked-in group RRSP.

Taxation issues

Contributions that the employer makes to a DC plan are deductible to the employer and are not considered a taxable benefit to the member. Contributions that the member makes to a DC plan are deductible to the member and will appear in box 20 of the T4 slip. The member can then deduct the amount in box 20 of the T4 slip as an RPP contribution when they file their federal income tax return.

Pension Adjustment (PA)

The annual PA under a DC plan is equal to the sum of the employer and member contributions to the DC plan for the current year.

If a member is accruing an annual pension benefit under a tax-sheltered retirement plan, such as a DC plan, the employer will be required to calculate a Pension Adjustment (PA) and report this PA 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 will reduce the member's RRSP deduction limit for the following year.

The purpose of a PA is to reflect the value of the tax-deferred benefits that an employee is receiving by being a member of an RPP or a DPSP. If a PA is reported by the employer on the member's T4 slip, then the amount of the PA will reduce the member's unused RRSP deduction limit for the **following year**. (There is a one-year deferral before the PA has an impact.)

PA reporting commenced 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 DC 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 DC 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 her 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 contributions made to Mr. Jones' DC plan. The PA that Mr. Jones receives reduces the contribution that he can make to a personal RRSP for the following year. Mrs. Smith receives no PA and as a result she can make a greater RRSP contribution than Mr. Jones to help compensate her for not being a member of a company tax-deferred retirement plan.

Options at termination or retirement

Under most provincial pension legislation, employer contributions to a DC plan vest after two years of membership. If a member terminates before two years of plan membership, then they forfeit the employer's contributions plus interest. However, if employer contributions to the DC plan are forfeited, the employer will be responsible for calculating a Pension Adjustment Reversal (PAR) equal to the amount of the employer contributions that have been forfeited. The PAR will increase the member's unused RRSP contribution room in the year of termination.

The concept of the PAR was introduced in the 1997 Federal Budget with the object of providing fair treatment to individuals who leave pension plans and receive far less from those plans than the amount by which their RRSP contribution limits have been reduced by PAs over the years. That is, an employer's contributions to a DC plan create a PA in the year of contribution, which means that the member's RRSP deduction limit for the following year is reduced. If the employee leaves the pension plan before they are vested, without a PAR, the member will not only lose the employer's contribution plus interest due to early termination, but they will also be penalized for past contributions due to the PA reporting, and thus, have a lower RRSP deduction limit due to those same forfeited contributions. To eliminate this inequity, a PAR can be calculated to allow the member to recover the lost RRSP deduction room that relates to the forfeited employer contributions.

If the member is not vested in the DC plan at the time of termination, they will not forfeit their own contributions or the interest they have earned on them. These monies can be paid in cash to the member, who will be subject to tax at their marginal tax rate. Withholding tax will be deducted from the payment. Alternatively, the member's contributions plus interest can be transferred on a tax-deferred basis to the member's own non-locked-in RRSP. They cannot transfer the funds to an RRSP in the name of their spouse. This transfer will not affect the member's unused RRSP deduction limit.

If the member is fully vested, then their contributions and those made by the employer plus interest will be locked-in under the relevant federal or provincial legislation. The member can then choose from the following maturity options for their vested DC plan funds:

Survivor benefits

If the member dies prior to retirement, assuming they were fully vested upon death, the balance in their DC plan can be rolled over on a tax-deferred basis to a surviving spouse's or common-law partner's RRSP/RRIF, which may or may not be locked-in depending on the jurisdiction in question. Alternatively, the funds could be used to purchase a life annuity.

If the member has already retired and is receiving an income from the DC plan at the time they die, they will have chosen benefit options for their spouse or common-law partner when they started receiving pension income. In this case, the pension will be paid as a "joint and survivor" pension, unless the member and their spouse or common-law partner waive this right. This allows the surviving spouse or common-law partner to receive a lifetime pension of at least 60% of the pension paid to the member.

On the death of the plan member, if they have named a minor (child or grandchild) as beneficiary of the DC plan, the DC plan funds can be used to purchase a term to age 18 annuity for the child or grandchild to avoid current taxation. Furthermore, if the child or grandchild (of any age) is mentally or physically infirm, the DC plan funds can roll over on a tax-deferred basis to the disabled child's or grandchild's own non-locked-in RRSP or RRIF or be used to purchase a life annuity to avoid current taxation.

If none of the above situations apply, the DC plan funds are fully taxable to the surviving beneficiary.