

COMMUNIQUÉ

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Flexible Pension Plans

Background

At its 54th meeting in March, 1998, CAPSA established a Task Force on Flexible Pension Plans in order to address various issues related to flexible pension plans. Some of these issues arose as a result of Revenue Canada's new rules on flexible pension plans issued in its Newsletter of November, 1996. The Canadian Institute of Actuaries (CIA) kindly agreed to assign a few of its members to provide the Task Force with technical and actuarial advice.

The Task Force presented its recommendations at the 55th meeting of CAPSA in September, 1998. Members of CAPSA reviewed the recommendations and agreed to bring them to the attention of their respective governments. This communiqué summarizes the recommendations of the Task Force.

Please note that this communiqué has been prepared to contribute to discussion of the harmonized regulation of flexible pension plans. It should not be construed as the official position of any provincial or federal government or agency.

What is a flexible pension plan?

Flexible pension plans are a type of pension plan developed by the pension community in response to income tax rules related to tax assisted retirement

savings introduced in the early 1990s. These income tax rules require that the RRSP contribution room of a member of a defined benefit pension plan be reduced by a Pension Adjustment which is equal to nine times the member's benefit accrual for the year, minus \$600. This "factor of nine" is an approximation of the intrinsic value of a defined benefit pension and assumes that the pension plan provides generous ancillary benefits. Many plans do not offer such generous ancillary benefits, however, and as a result the intrinsic value of the member's accrued pension benefit (and the corresponding reduction in RRSP contribution room) may exceed its actual value.

A flexible pension plan is a plan that allows members to make voluntary defined benefit contributions (called "optional ancillary contributions" in the Revenue Canada Newsletter) to a flexible component of the plan. The accumulated contributions to this component are then used to purchase or improve ancillary benefits at termination, retirement or death. Such improvements do not influence the rate of the basic pension accrual, and therefore do not affect the calculation of the Pension Adjustment. However, since ancillary contributions do increase the overall value of a member's pension benefit, they are a tax efficient means of increasing retirement savings without reducing RRSP room.

The recommendations contained in this Communiqué only apply to situations where a member makes optional ancillary contributions to purchase or improve ancillary benefits. They do not apply to situations where the employer makes such contributions in respect of a member.

What issues regarding flexible pension plans were studied by the CAPSA Task Force?

The following issues respecting flexible pension plans were studied by the task force:

1. How should optional ancillary contributions be classified?
2. How should the Revenue Canada forfeiture rule be dealt with?
3. Should the 50% employer funding rule apply to optional ancillary contributions?
4. Should optional ancillary contributions be locked-in?
5. How should optional ancillary contributions be invested?
6. What basis should be used to convert optional ancillary contributions into ancillary benefits?
7. What basis should be used when members elect to transfer ancillary benefits?

Recommendations of Task Force

1. Classification

Alternatives discussed were to treat optional ancillary contributions as additional voluntary contributions, as required contributions, or as a new, third class of contribution. Since optional ancillary contributions as conceived by the Revenue Canada Newsletter are neither required contributions (since they do not generate pension adjustment), nor voluntary contributions (since they can only be used to purchase ancillary benefits), the Task Force concluded that the best course is to create within pension standards legislation a new third class of contribution with its own characteristics.

Recommendation: Create a third class for optional ancillary contributions.

2. Forfeiture of Excess Contributions

In its Newsletter, Revenue Canada stated that if the value of ancillary benefits is lower than ancillary contributions, then the excess contributions cannot be cashed in but must remain in the plan. Pension regulators were concerned about this rule, because it would mean that members of a pension plan could lose some of their optional ancillary contributions and/or earnings thereon, which is contrary to the regulators' desire to protect plan members. However, Revenue Canada and Finance Canada clarified that the forfeiture requirement is necessary to ensure that the flexible component of a pension plan is not characterized as a money purchase provision. Furthermore, the forfeiture requirement is also necessary to prevent flexible pension plans from being used to provide tax-deferred savings in excess of the intended limits for retirement savings.

The Task Force recommended that forfeitures be allowed to occur (and as such be left in the plan) as long as a generic statement of the possibility of forfeiture is provided to all eligible employees, with the annual statement to members and at enrolment. The Task Force believed that since optional ancillary contributions are an optional means of tax-assisted savings, the employer's responsibility is mainly that of advising and warning. Furthermore, it was felt that once a member has been informed that forfeitures may occur, the member must take some responsibility for the decision to contribute.

Recommendation: Allow forfeitures to occur as long as appropriate disclosure is provided to members.

3. 50% Employer Funding Rule

Optional ancillary contributions are optional and intended to provide members with additional ancillary benefits without increasing the direct costs of the pension plan. The Task Force recommended that optional ancillary contributions be exempt from the 50% rule. The plan could nevertheless apply the 50% rule, but only to the aggregate of the basic and ancillary benefits, in accordance with the Revenue Canada Newsletter.

Recommendation: Exempt optional ancillary contributions from the 50% employer cost rule.

4. Locking In

Under the Revenue Canada Newsletter, optional ancillary contributions are effectively "locked-in" as long as the basic benefits remain in the plan. However, optional ancillary contributions are made by members on a voluntary basis and generate benefits that are in excess of the basic pension promise.

The Task Force therefore recommended that optional ancillary contributions not be locked in when the transfer of aggregate benefits occurs.

Recommendation: Exempt optional ancillary contributions from locking-in rules.

5. Investments

Some plan sponsors may prefer to give members the ability to choose how their optional ancillary contributions are invested (from within a certain group of available investments). Others may not be able to support the added administration and cost of such a set-up. The Task Force recommended that each plan state how optional ancillary contributions will be invested. This may be based on the member's investment choices. If no investment choices are offered, interest on optional ancillary contributions should be credited at the rate of return of the plan fund.

Recommendation: Require the plan to state how optional ancillary contributions will be invested. If investment choices are offered to members, the investment rate will vary according to the investments chosen. If no investment choices are offered to members, interest on optional ancillary contributions should be credited at the rate of return of the plan fund.

6. Basis to Determine Ancillary Benefits

The Task Force considered what basis should be used to determine the amount of ancillary benefits which can be derived from the member's optional ancillary

contributions account for a member who receives a benefit in the form of monthly pension payments from the plan fund. The objective is to protect members from the use of overly conservative bases. It should be noted that all or part of the basic and/or ancillary benefits could be provided through the purchase of an annuity. The Task Force recommended that the calculation be done in accordance with accepted actuarial practice.

The CIA is currently developing a new actuarial basis for calculating transfer values. The new basis should be used once it becomes accepted actuarial practice. In the interim, a reasonable basis, such as but not limited to, the funding basis, the current CIA transfer value basis or a smoothing of the current CIA transfer basis, would be acceptable as long as it is acceptable to Revenue Canada.

Recommendation: In converting optional ancillary contributions to ancillary benefits, use the new actuarial basis which is being developed by the CIA, when it becomes accepted actuarial practice. In the interim, use a reasonable basis for such conversion.

7. Amount Payable on Termination

It is desirable that, on a member's termination from a flexible pension plan, the amount payable in respect of the member's optional ancillary contribution account be equal to the amount accumulated in the account. However, this may not always be permitted under the tax rules. It would not be permitted, for example, if the amount in the member's account could not be fully utilised in the provision of ancillary benefits to the member (unless, in respect of basic benefits, the member is receiving only a refund of contributions).

Recommendation: Require that the termination benefit in respect of a member's optional ancillary contribution account be equal to the amount accumulated in the account, or such lesser maximum as may be permitted under the tax rules.