

SUBJECT: **Prescribed Compensation for Registered Pension Plans**

DATE: September 1, 1998

NO.: **IC98-2**

1. In this circular we at Revenue Canada explain our administrative requirements which apply to prescribed amounts of compensation. Prescribing compensation enables defined benefits to be provided, or money purchase contributions to be made, for periods of reduced services under a registered pension plan (RPP) without violating the pension adjustment limits in subsections 147.1(8) and (9) of the *Income Tax Act*.

This circular will be of interest primarily to RPP administrators and the pension industry. Although RPP members may find it interesting, they should consult their plan administrators if they have questions about benefits provided under their RPPs.

The circular is divided into five parts.

PART A – COMPENSATION AND PRESCRIBED COMPENSATION

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When we refer to the Regulations, we mean the *Income Tax Regulations*. All other references to sections, subsections, and paragraphs refer to those of the *Income Tax Act*.

PART A – COMPENSATION AND PRESCRIBED COMPENSATION

What compensation is

2. Compensation is defined in subsection 147.1(1). An individual's compensation from an employer for a calendar year has three parts under the definition:

- total salary, wages, and other amounts, such as the benefit from the use of an automobile, for the individual's employment with an employer or an office for which the individual is paid by the employer, that

the individual is required by sections 5 and 6 to include in income for the year (or would be compensation but for paragraph 81(1)(a) of the *Income Tax Act* and the *Indian Act*). Compensation may not include an amount that:

- relates to a period throughout which the individual is not resident in Canada, as defined in subsection 250(1); and
 - is not attributable to an office or employment in Canada or is exempt from tax in Canada under a tax treaty or convention;
- (b) a prescribed amount, which is referred to in this circular as prescribed compensation; and
- (c) remuneration for a period during which the individual is not a resident of Canada, but only to the extent that the remuneration is acceptable to the Minister of National Revenue.

This circular deals mainly with the application of paragraph (b) of the definition, but also refers to paragraph (c) of the definition in 20 below.

Remuneration is not defined in the legislation that applies to RPPs. An individual's remuneration from an employer is considered to include all amounts taxable as income under section 5 or 6 of the *Income Tax Act*. For non-residents, remuneration includes amounts that would be taxable if the individual was resident in Canada. It may also include amounts not pensionable under the plan.

The importance of compensation for RPPs

3. Compensation is an important part of the restrictions under the Act and Regulations for RPP contributions and benefits, including:

- the pension adjustment (PA) limits (see 0 below);
- the defined benefit maximum pension rule (see 26 below); and
- the additional benefits which may be paid under approved downsizing programs (see 29 below).

Purpose of prescribed compensation

4. Prescribed compensation allows a notional amount of remuneration to be included in an individual's compensation during a period when the individual's rate of pay is less than usual because of a period of reduced services. It allows money purchase contributions to continue to be made and benefits under defined benefit provisions to continue to accrue without exceeding the restrictions for compensation. Without prescribed compensation, the restrictions that the PA limits in subsections 147.1(8) and (9) impose could be exceeded in a low-pay year. This would cause the plan's registration to become revocable under paragraph 147.1(11)(c). The maximum pension that a

member could receive under a defined benefit provision, under section 8504 of the Regulations, would be less without prescribed compensation, as would the maximum that applies to additional benefits payable under approved downsizing programs in subsection 8505(3) of the Regulations.

Pension adjustment (PA) limits

5. The system of tax assistance for retirement savings is based on a uniform limit of 18% of compensation. This applies comprehensively to tax assisted savings in employer-sponsored RPPs, deferred profit sharing plans (DPSPs), and individual registered retirement savings plans (RRSPs). The PA limits, stated in subsections 147.1(8) and (9) for RPPs and 147(5.1) for DPSPs, are part of the provisions imposing these comprehensive limits. Failure to respect the PA limits for any plan member causes the plan to be revocable.

The PA measures the level of retirement savings in a year for a member related to his or her employer under defined benefit and money purchase provisions of RPPs, DPSPs, and some unregistered retirement plans or arrangements. The PA is equal to the member's total pension credits for the year related to the member's employer. Sections 8301 and 8302 of the Regulations state most of the rules for calculating pension credits. A pension credit reflects the value of the benefit that a member earns in the year under each DPSP or RPP benefit provision in which the member participates.¹ For a money purchase provision, the pension credit is generally the total of the contributions made by or for a member and any amounts attributable to surplus, forfeitures, or earnings on forfeitures that are allocated to the member. For more information on PAs, see the *Pension Adjustment Guide (T4084(E))*. The guide is available at all Revenue Canada tax services offices.

Under subsection 147.1(8), an RPP (other than a multi-employer plan) becomes revocable if the PA of a member for a year related to an employer is more than the lesser of:

- the money purchase limit² for the year; and
- 18% of the member's compensation from the employer for the year.

Further, a member's total PAs for all employers who do not deal with each other at arm's length at any time in the year may not be more than the money purchase limit for the year.

¹ Under section 8308.1 or 8308.3 of the Regulations, pension credits may have to be calculated for individuals who participate in a foreign pension plan or a specified retirement arrangement.

² The money purchase limit is defined in subsection 147.1(1). For years after 1995 and before 2003 it is \$13,500. It increases to \$14,500 in 2003 and \$15,500 in 2004. Beginning in 2005, the limit will be indexed in line with increases in the average wage. If the average wage decreases in a year, the money purchase limit will be the same as the previous year's limit.

A similar limit in subsection 147.1(9) applies to multi-employer plans (MEPs), other than specified multi-employer plans (SMEPs). MEPs are generally pension plans in which it is reasonable to expect that at no time in the year are more than 95% of the active plan members employed by a single participating employer or by a related group of participating employers. Under a multi-employer plan, the total of a member's pension credits for a year for an employer must not be more than the lesser of:

- the money purchase limit for the year; and
- 18% of the member's compensation from the employer for the year.

Further, a member's total pension credits under the plan for all participating employers may not be more than the money purchase limit for the year.

Specified Multi-Employer Plan (SMEP)

6. Many of the restrictions that apply to other RPPs do not apply to SMEPs. SMEPs are excluded from the application of the PA limits in subsections 147.1(8) and (9) and the maximum pension rule in subsection 8504(1) of the Regulations. Instead of the PA limits, SMEPs have to meet a reasonableness test for contributions imposed by paragraph 8510(7)(a) of the Regulations. The test requires that, whenever new contribution rates are established, it is reasonable to expect that the total employer and employee contributions to be made each year will not be more than 18% of the total compensation of all employees under the plan. In addition, the prescribed compensation rules do not apply to periods of reduced pay and temporary absence under SMEPs.

Under paragraph 8510(7)(b) of the Regulations, SMEPs that have a money purchase provision need to limit the pension credits to the limits of subsection 147.1(9), even though that subsection is not specifically applicable to SMEPs. There may be circumstances when the plan does not comply with these limits, such as during a period of absence when contributions continue for the member. SMEPs having such plan terms must receive acceptance from the Minister of National Revenue, otherwise they can be revoked.

PART B – CALCULATING PRESCRIBED COMPENSATION

Calculating prescribed compensation

7. Section 8507 of the Regulations states the method for determining prescribed compensation in relation to the definition of compensation in subsection 147.1(1). Prescribed compensation applies during:

- periods of disability (see 8 below); and
- periods of reduced pay or temporary absence, including periods of parenting, which meet the requirements for qualifying periods (see 9 below).

Periods of disability

8. For compensation to be prescribed in a period of disability, the member must be disabled as defined in subsection 8500(1) of the Regulations throughout a period that is after 1990. "Disabled" means that the member suffers from a physical or mental impairment that prevents the member from performing the duties of employment in which the member was engaged before the impairment started. Under a money purchase provision, compensation for a period of disability may be prescribed for an unlimited time. For defined benefits to accrue during the period of disability, subparagraph 8503(3)(a)(iv) of the Regulations requires that the member had been employed in Canada by, and received remuneration from, a participating employer before the period of disability. It also prohibits the accrual of benefits under defined benefit provisions during any part of a period of disability after 1990 in which an individual is a person connected with a participating employer.³

As stated in paragraph 8507(2)(a) of the Regulations, the amount of prescribed compensation for a period of disability is calculated as follows

- the remuneration that it is reasonable to expect the member would have received from the employer if the member rendered services throughout the period on the member's regular basis;
minus
- the member's actual remuneration from the employer for the period.

When determining the amount that it is reasonable to expect the individual would have received from the employer, reasonable adjustments have to be made for irregular amounts, such as bonuses, if these amounts were paid in the past.

Example 1

A money purchase RPP provides for an employer to contribute 10% of a member's basic salary. Employees do not contribute to the plan. In 1996, a member is employed full-time and earns a basic salary of \$42,000. The member has no other compensation in the year. There are no forfeitures or surplus in the plan. The PA of the member for the year is: 10% of \$42,000 = \$4,200.

The PA limit for the member under paragraph 147.1(8)(a) is the lesser of:

- the money purchase limit for 1996, \$13,500; and

³ Connected persons participating under a money purchase provision who become disabled may continue to accrue benefits under the provision. Compensation may be prescribed for these connected persons. However, an amendment to the legislation is being considered to disallow prescribing compensation for these individuals.

- 18% of the member's compensation of \$42,000, which is \$7,560.

The PA of \$4,200 is within the PA limit of \$7,560.

In 1997, the member becomes disabled after 2 months of regular, full-time employment. Instead of the member's expected salary of \$42,800, the member receives \$7,200 in compensation from the employer for the period before the disability. The plan provides that contributions will continue during a period of disability as though the member were making regular earnings. The employer contributes \$4,280 (10% of \$42,800) so the PA is \$4,280. The member is not employed by any other employer in the year, and participates in no other RPP or DPSP.

Prescribed compensation allows another amount to be included in the member's compensation. The prescribed compensation calculated using the formula shown above is: \$42,800 minus \$7,200 = \$35,600.

The PA limit, without prescribed compensation, would be the lesser of:

- 18% of \$7,200, which is \$1,296; and
- the money purchase limit for the year, \$13,500.

The PA limit without prescribed compensation would be \$1,296. As the PA of \$4,280 would be more than the PA limits, the plan's registration could be revoked.

By prescribing an amount of compensation, the PA limit is the lesser of:

- 18% of \$42,800, which is \$7,704; and
- the money purchase limit for the year, \$13,500.

The actual PA of \$4,280 is within the PA limit of \$7,704.

The entire amount of \$35,600 is prescribed even though the amount is not needed to support the PA.

Qualifying periods

9. Qualifying periods are defined in paragraph 8507(3)(a) of the Regulations. They include periods after 1990 which meet the definition of either an eligible period of reduced pay (see 10 below) or an eligible period of temporary absence (see 11 below). Also, the periods have to meet the conditions listed in 12 below.

Cumulative limits apply to qualifying periods under paragraph 8507(2)(b) of the Regulations. The cumulative limits are:

- five years of equivalent full-time remuneration for periods of reduced pay and temporary absence; and
- three more years of equivalent full-time remuneration for periods of parenting.

These cumulative limits apply to an individual's employment with an employer. If an individual changes employers, a new cumulative limit will apply as long as the new employer

deals at arm's length with the previous employer and was not a participating employer in the previous employer's RPP.

Eligible periods of reduced pay

10. An eligible period of reduced pay is defined in subsection 8500(1) of the Regulations. It is a period of employment with an employer during which the remuneration received by the member is less than what the member could reasonably expect to have received if the member worked regularly at a rate of pay consistent with what the member was receiving before the period. The regular basis on which the member worked will usually be either full-time or part-time. If the member is a person who is connected with the employer at any time during the period, that part of the period is not an eligible period of reduced pay. Periods of disability are also not eligible periods of reduced pay. Under the definition, the member must have been employed by the employer for at least 36 months before an eligible period of reduced pay can occur. However, in certain circumstances of broadly based wage rollbacks, the 36 months of employment required may not apply (see 14 below).

Eligible periods of temporary absence

11. As defined in subsection 8500(1) of the Regulations, an eligible period of temporary absence is a period throughout which the member does not render services to the employer due to a leave of absence, layoff, strike, lock-out, or any other circumstance that is accepted in writing by the Minister of National Revenue. Circumstances may include but are not limited to periods such as:

- educational leave;
- leave due to short-term appointments to federal or provincial governments, committees, or commissions; and
- periods of loan to a union, educational institution, or charitable organization.

An eligible period of temporary absence does not include a period of disability nor any period during which the individual is a person connected with the employer.

Please write to the following address if you want to determine whether a particular circumstance not mentioned above is acceptable:

Registered Plans Division
Revenue Canada
Ottawa ON K1A 0L5

You can also call (613) 954-0419 (English service) or (613) 954-0930 (French service).

Qualifying period conditions

12. For an eligible period of reduced pay or temporary absence to be a qualifying period for prescribed

compensation, subsection 8507(3) of the Regulations imposes the following conditions:

- Defined benefit provisions of RPPs have to specifically provide for lifetime retirement benefits to accrue as though the member was performing more services and was earning more remuneration than is the case during the period. Similarly, money purchase provisions of RPPs must specifically provide for contributions to be made as though the member was earning more remuneration than is the case during the period. The money purchase contributions or defined benefit accruals must continue under terms of the plan that apply for periods that are not regular periods of employment.
- The additional benefits or contributions must be included in the member's PA for the year. Under a defined benefit provision, if the additional benefits are credited at a later date retroactively, a past service pension adjustment (PSPA) would generally result instead of a PA. There would be no prescribed compensation for the period.
- Contributions to a Deferred Profit Sharing Plan (DPSP) or a Money Purchase (MP) provision in which the employer or non-arm's length employer do not participate cannot be made by or for the employee for the period.
- Defined benefits may not accrue for the period under an RPP in which the employer or a non-arm's length employer does not participate.

Part-time employees

13. A period of part-time employment may only be considered an eligible period of reduced pay if the basis of employment is reduced from the previous period. The employer does not have to impose a reduced basis of employment. The employee can reduce the basis of employment.

Part-time employment does not lead to an eligible period of temporary absence as long as the member continues to give services to the employer, even if on a reduced basis (see Example 4 below).

Wage freezes and rollbacks

14. A wage freeze results in a permanent wage adjustment rather than a temporary wage reduction. As a result, it does not qualify as an eligible period of reduced pay. Compensation is not prescribed for wage freezes.

Broadly based wage rollbacks under austerity programs may qualify for prescribed compensation, even if there is no reduction in time worked by plan members. For such rollbacks, the 36-month employment requirement under the definition of eligible period of reduced pay may not always apply. Contact us at the address given in 11 above to determine if a wage rollback situation qualifies for

prescribed compensation.⁴ Give us the details of the program, including:

- the circumstances leading to the rollback (e.g. legislated or negotiated);
- the number of employees affected;
- the duration of the rollback;
- the number of employees who have not been employed by their current employer for 36 months and their length of employment; and
- the plan name and registration number.

Five-year cumulative limit

15. Under subsection 8507(2) of the Regulations, the amount of prescribed compensation for a qualifying period is the additional remuneration that the member would have earned if the member had rendered services regularly. This is subject to a cumulative limit of five years of post-1990 full-time equivalent remuneration, which can be prescribed for employment with one employer. Three more years of full-time equivalent remuneration may be prescribed for periods of parenting (see 16 below). As provided under subsection 8507(4) of the Regulations, the cumulative limit applies to the total of all qualifying periods for:

- employment with the current employer;
- employment with any other employers that participate in an RPP in which the employer participates for the benefit of the individual; and
- the RPPs of any employers that do not deal at arm's length with the current employer.

Once the cumulative limit has been reached, the registration of the plan could become revocable if benefits continue to accrue during an eligible period of reduced pay or temporary absence. This depends on whether money purchase contributions or defined benefit accruals cause the PA limits in subsections 147.1(8) and (9) to be exceeded.

Example 2 – Basic calculation for qualifying periods

A member takes three months of unpaid leave of absence from regular, full-time employment. This is the member's first interruption in a career with this employer and the member has never been employed by any other employer. If the member had worked for the full year, the member would have earned \$40,000. As a result of the leave of absence, the member earned \$30,000. Contributions are made to the

⁴ The legislation does not permit periods of wage rollback to qualify for prescribed compensation if there is no reduction in time worked because the period is considered to be a regular period of employment and the member is considered to be working regularly. An amendment to the legislation is under consideration to allow such periods to qualify for prescribed compensation. In the meantime, we are allowing some RPPs to be administered as though prescribed compensation applied if the wage rollback is broadly based and resulted from an austerity program.

money purchase RPP that the member's employer sponsored as though the member were working the full year at the full rate of pay.

Since this is the first qualifying period in the member's career and it is less than five years, there is no need to consider whether the member's five-year cumulative limit has been used. The prescribed compensation for the period of temporary absence is \$10,000. In this case, calculate it as follows:

- the remuneration that it is reasonable to expect the member would have received from the employer for the leave of absence (\$10,000);
minus
- the actual remuneration for the period of absence (\$0).

The prescribed compensation for the year, \$10,000, will ensure that the PA limits in subsections 147.1(8) and (9) are not exceeded, even though contributions continue to be made as though the member was working for the full year at the usual rate of pay.

The member has now used part of the five years of full-time equivalent remuneration that can be prescribed. The part used in the year is the additional compensation fraction under subsection 8507(5) of the Regulations.

The additional compensation fraction is E/D where:

E is the prescribed compensation amount for the year; and

D is the remuneration the member would have received from the employer if the member worked full-time throughout the year at a rate of remuneration consistent with the member's remuneration before the period.

In this case, $E = \$10,000$ and $D = \$40,000$.

$E/D = 0.25$

The additional compensation fraction is 0.25.

The plan administrator has to total all additional compensation fractions for the member to ensure that the five-year cumulative limit is not exceeded. The resulting cumulative additional compensation fraction⁵ is a measure of the amount of prescribed compensation that has been used up for a member for an employer.

As stated earlier, this is the first leave of absence in the member's career with the employer and the member has never worked for any other participating employer. The cumulative additional compensation fraction is 0.25. This leaves a potential of 4.75 years worth of full-time remuneration for future prescribed compensation for that employer.

Example 3 – Five-year cumulative test

Several years later, the member is still employed by the same employer. The member has taken several unpaid leaves of

absence totalling 4.5 years from regular full-time employment with the employer. Each time, contributions were made to the money purchase RPP sponsored by the member's employer as though the member was working normally and at a full rate of pay. The member will be taking another unpaid leave of absence, this time for a full calendar year. The employer estimates that the member would normally have earned \$50,000 in the year, based on the increases the employer has paid to other employees in similar positions. Due to the leave of absence, the member will have no earnings in the year.

This time, the administrator will have to take into account the five-year cumulative limit to determine how much compensation will be prescribed.

First the administrator does the basic calculation, as shown in Example 2 above. In this case, the prescribed compensation is $\$50,000 - \$0 = \$50,000$.

The five-year cumulative limit test is a formula from paragraph 8507(2)(b) of the Regulations. It is:

$(5 - C) \times D$, where

C is the cumulative additional compensation fraction; and

D is the remuneration the member would have received from the employer if the member worked full-time throughout the year at a rate of remuneration consistent with the member's remuneration before the period.

Since contributions have previously been made for the member during leaves of absence totalling 4.5 years, the cumulative additional compensation fraction is 4.5.

$C = 4.5$

$D = \$50,000$

$(5 - 4.5) \times D = 0.5 \times \$50,000 = \$25,000$

As the five-year cumulative limit is attained in the year, the administrator can only prescribe an additional \$25,000 as compensation under subsection 147.1(1). The plan's registration will be revocable if contributions made for the member result in a PA that is more than the limits in subsections 147.1(8) and (9).

Example 4 – Regular part-time employee

A member takes a three-month unpaid leave of absence from regular, part-time employment. On a full-time basis, the member's remuneration would normally be \$36,000 for a full year. If the member had worked part time for the full year, the member would have had earnings of \$18,000. This is the member's first interruption in a career with this employer. The member previously worked for another employer who is not at arm's length with the current employer, but that employer did not sponsor a pension plan.

This member's regular remuneration for the 3-month period, on a part-time basis, would have been \$4,500. The actual remuneration for the unpaid leave of absence is \$0. The

⁵ Defined in subsection 8507(4) of the Regulations.

prescribed compensation using the basic calculation as in Example 2 above is:

$$\$4,500 - \$0 = \$4,500$$

The administrator must determine the additional compensation fraction, E/D, where:

E is the prescribed compensation amount for the year; and

D is the remuneration the member would have received from the employer if the member worked full time throughout the year at a rate of pay consistent with the member's remuneration before the period.

$$\frac{E}{D} = \frac{\$4,500}{\$36,000} = 0.125$$

Since the additional compensation fraction is 0.125, the member has room for 4.875 more years of prescribed compensation based on full-time earnings.

Periods of parenting

16. Paragraph 8507(3)(b) of the Regulations defines a period of parenting of an individual for prescribed compensation purposes. It starts at the birth of a child of whom the individual is a natural parent or when the individual adopts a child and ends 12 months later. Periods of parenting must meet the conditions for qualifying periods stated in 12 above, including the requirement that they meet the definition of either eligible period of reduced pay or eligible period of temporary absence.

Three-year cumulative limit

17. Calculating prescribed compensation for periods of parenting is similar to calculating prescribed compensation for other qualifying periods. Under subsection 8507(3) of the Regulations, a cumulative limit of three years of equivalent full-time remuneration on qualifying periods which are also periods of parenting is added to the general five-year cumulative limit on qualifying periods. Subsection 8507(4) of the Regulations requires that the three-year cumulative limit apply to the total of all periods of parenting for:

- employment with the current employer;
- employment with any other employers that participate in an RPP in which the employer participates for the benefit of the individual; and
- RPPs of any employers that do not deal at arm's length with the current employer.

Example 5 – Parenting

During a calendar year, a member takes a six-month period of parenting leave, starting at the birth of the member's child. The member usually works full-time. If the member had worked for the full year, the member would have earned \$38,000. During the six months when the member was not on leave, the member earned \$19,000. During the parental leave, the member earned \$11,000. Under the RPP

sponsored by the member's employer, defined benefits continue to accrue as though the member was still working at a regular rate of pay. This is the member's first period of parenting.

Because this parental leave is for less than 12 months and is the first period of parenting in the member's career, there is no need to consider whether the member's three-year cumulative limit has been used up. The prescribed compensation, using the basic calculation as in Example 2 above is: $\$19,000 - \$11,000 = \$8,000$

The plan administrator must determine how much of the member's three-year limit on prescribed compensation for periods of parenting this leave will use.

To do this, the administrator calculates the ratio of the basic calculation (as in 15 above) for the period of parenting to what full-time, full-year remuneration would have been if not for the period of parenting. In this case, it is:

$$\frac{\$8,000}{\$38,000} \text{ or } .210$$

The member has used .210 of a year out of the potential three years for periods of parenting for which compensation would be prescribed.

Prescribed compensation applies for each period of parenting during which benefits usually accrue in an RPP. In the simplest scenario, a full-time RPP member would have prescribed compensation for three separate, full-time periods of parenting.

If a full year of prescribed compensation does not result from a period of parenting as in the above example, the part left will form an additional period of parenting. In the example, there would be 2.79 (3.0 – .210) years worth of prescribed compensation for parental leave remaining. For example, the 2.79 years could become at least three separate periods of parenting leave: two one-year periods and one period of .79 of a year. Each period would have to meet the definition of period of parenting and the conditions for a qualifying period for compensation to be prescribed.

Period of parenting that is more than 12 months

18. If a member's period of reduced pay or temporary absence for parenting is more than the 12 months stated in the definition of period of parenting in paragraph 8507(3)(b) of the Regulations, only the first 12 months generate prescribed compensation for a period of parenting. If the plan provides for benefits to continue to grow normally after the first 12-month period, the remaining period is treated as any other qualifying period. Therefore, compensation can continue to be prescribed as long as the condition for a qualifying period is met and the five-year limit for eligible leaves of absence or reduced pay has not been reached.

Plan administrator's responsibility

19. It is the responsibility of the plan administrator to ensure that the plan is administered according to its terms as registered. The plan must meet the prescribed conditions for registration stated in subsection 8501(1) of the Regulations, which include the condition that there be no reason to expect that the plan may become revocable due to the PA limits in subsections 147.1(8) and (9) being exceeded.

Depending on the plan terms and on the existence of non-arm's length employers who sponsor RPPs, it may be necessary for the plan administrator to ensure that the cumulative limits for qualifying periods have not been exceeded. Accordingly, the administrator may have to keep track of prescribed compensation accumulated for each member for employment with:

- the current employer;
- other employers who participate in the plan; and
- employers who do not deal at arm's length with the current employer.

Since there is no cumulative limit on prescribed compensation for periods of disability, the plan administrator does not have to keep track of the cumulative amounts of prescribed compensation for such periods.

PART C – SPECIAL SITUATIONS

Foreign service

20. For a qualifying period that is also a period of foreign service, the Minister has imposed certain additional conditions which further restrict the amount of compensation which can be prescribed.

For more information about how foreign service affects an RPP, see our newsletter called *Foreign Service Newsletter* 93-2.

Loaned employees

21. Under subsection 8308(7) and subsection 8507(5) of the Regulations, special rules apply when a member takes an eligible leave of temporary absence from employment with one employer under certain circumstances. Prescribed compensation will apply for the leave of absence without reducing the member's five-year cumulative limit under the following conditions:

- The borrowing employer is at arm's length with the lending employer and does not participate in the lending employer's RPP.
- The member gives services to the borrowing employer and receives remuneration from that employer for those services.
- Benefits continue to accrue to the member under a defined benefit provision of the plan in which the lending employer participates or the lending employer continues

to make contributions for the member to a money purchase provision of the plan.

If these conditions are met, under paragraphs 8308(7)(d) and (e) of the Regulations defined benefit accruals and money purchase contributions that relate to the remuneration received from the borrowing employer will be reflected in a separate PA for that employer. Depending on the plan terms, the lending employer may calculate the employee's PA based on earnings that would have been paid if the employee was not on loan. Under paragraph 8308(7)(c) of the Regulations, the borrowing employer is considered to be a participating employer for purposes of the definition in subsection 147.1(1) and the PA limits in subsections 147.1(8) and (9). The effect of subsection 8308(7) of the Regulations is that an amount that would otherwise be the member's pension credit for the lending employer is the pension credit of the borrowing employer.

Salary deferral leave plans

22. By participating in a salary deferral leave plan as described in paragraph 6801(a) or (b) of the Regulations, an employee can defer receiving part of his or her salary or wages for tax purposes. Employees can use such plans in co-operation with their employers to self-fund sabbaticals and other leaves of absence.

Under paragraph 8508(a) of the Regulations, a period throughout which an employee defers salary or wages under a written agreement that is part of a salary deferral leave plan, described in paragraphs 6801(a) or (b) of the Regulations, is considered to be an eligible period of reduced pay. As a result, the deferral period may be a qualifying period for prescribed compensation.

Under paragraph 8508(b) of the Regulations, the rate of remuneration to be used for calculating prescribed compensation during the deferral period is the amount that it is reasonable to consider the employee would have been paid but for the salary deferral leave plan.

Retroactive contributions and benefit accruals

23. Under subsections 8308(4), (5), and (6) of the Regulations, the retroactive accrual of defined benefits and retroactive money purchase contributions for periods of reduced services may result in redetermined PAs for the years to which the accruals or contributions relate. The PA limits in subsections 147.1(8) and (9) are based on the redetermined PAs for those years. The compensation part of the limits includes prescribed compensation as if the defined benefits accrued and the money purchase contributions were made currently rather than retroactively. It is the responsibility of the plan administrator to ensure that the retroactive defined benefit accrual or money purchase contribution will not cause the PA limits based on prescribed compensation to be exceeded retroactively.

Retroactive defined benefit accruals

24. Some defined benefit provisions provide that benefits will continue to accrue during a period of reduced services. In other cases, the member or employer may decide after the period to recognize the period as pensionable service. In accordance with subsection 8308(4) of the Regulations, providing these retroactive benefits will result in either increased PAs or a PSPA, depending on when they are provided to the member.

The redetermination of PAs under subsection 8308(4) of the Regulations applies only if retroactive benefits become provided on or before April 30 of the year after the calendar year in which the period of reduced services ends. This means that when such a period spans two or more years, the decision as to whether to provide benefits for all or any part of the period can be deferred until after the end of the period.

If the retroactive benefits are provided after April 30 of the year after the year in which the member's period of absence ended, then the plan administrator has to calculate and report a PSPA for the member. We have to certify the PSPA. The member's cumulative compensation fraction is not affected.

Retroactive money purchase contributions

25. In accordance with subsections 8301(4) and 8301(11) of the Regulations, all contributions to money purchase provisions are included in the PA for the year in which they are paid, except that contributions paid by the end of February of the next year may be included in the previous year's PA if they can reasonably be considered to relate to the previous year.

The special rules in subsections 8308(5) and (6) of the Regulations apply to a retroactive money purchase contribution where the contribution is made or a commitment to contribute is made, on or before April 30 of the year after the calendar year in which the period of reduced services ends. Where the special rules apply, the redetermined PA of an individual for each year that includes a period of reduced services for which retroactive contributions are made is considered to be the amount that would have been the individual's PA if the retroactive contributions had been made in the year to which they relate.

PART D – MAXIMUM PENSION RULES

The Maximum pension rule

26. The maximum pension rule is stated in section 8504 of the Regulations. It limits the amount of pension that may be provided to a member under a defined benefit provision of an RPP. Since the maximum pension calculation is based partly on a member's compensation, prescribing compensation may prevent a reduction in a member's maximum pension for situations where the member has a period of reduced services at a time of high earnings.

Basic maximum pension rule

27. As stated in subparagraph 8504(1)(a)(ii) of the Regulations, for years in which the member was not, at any time, a person connected with a participating employer, the maximum amount of annual lifetime pension in the year in which the pension starts to be paid is the lesser of:

- 2% of highest average compensation, indexed to the year it started multiplied by the number of years, including any part of a year, of pensionable service; and
- the defined benefit limit for the year multiplied by the number of years, including any part of a year, of pensionable service.

Generally, highest average compensation of a member, as defined in subsection 8504(2) of the Regulations, means one-third of the member's compensation for the three non-overlapping, 12-month periods of highest compensation, including prescribed compensation. In determining highest average compensation, the total amount of compensation received by the member for periods of employment from participating employers in a calendar year is adjusted to reflect increases in the average wage after 1986.

Pensionable service means those periods of service for which benefits are provided under the provisions of a plan.

Maximum pension rule for connected persons

28. The maximum lifetime retirement pension for a connected person, as stated in subparagraph 8504(1)(a)(i) of the Regulations, is combined with the maximum pension described in 27 above to determine the entire maximum pension for a member who is a connected person under a defined benefit provision.

For each calendar year after 1990 during which the member was, at any time, a person connected with a participating employer, the maximum level of annual lifetime pension for the year in which the pension starts to be paid is the lesser of:

- 2% of the member's indexed compensation for the year; and
- the defined benefit limit for the year the pension starts multiplied by the fraction of the year that is pensionable service of the member under the provision.

For this purpose, indexed compensation means compensation, including prescribed compensation, adjusted to the year the pension starts according to increases in the average wage.

Prescribed compensation generally does not arise for a period when a person is connected with a participating employer because of the restrictions on service accruals during periods of reduced services which apply to these individuals. However, the connected person maximum pension rule applies to a year even if the member was connected with the employer for only part of the year. A

member's compensation for such a year could include prescribed compensation for the part of the year during which the member was not connected with the employer.

Special maximum pension rule under approved downsizing programs

29. In connection with a downsizing program that the Minister of National Revenue has approved, subsection 8505(3) of the Regulations provides that certain otherwise non-permissible benefits may be provided under a defined benefit provision. In certain circumstances, more benefits may be provided to qualifying individuals without being linked in any way to service. A special maximum pension rule applies to these additional benefits. Under this rule, the maximum amount of additional annual lifetime pension for the year in which the pension starts to be paid is the product of:

- the lesser of 2% of the member's highest average compensation (see 27 above) and the defined benefit limit for the year; and
- the number of years, including any part of a year, from the time the individual terminates employment to the individual's 65th birthday, up to a maximum of seven years.

Prescribed compensation can form part of the highest average compensation part of the limit if the member has had any qualifying periods or periods of disability.

PART E – PLAN WORDING REQUIREMENTS

Plan wording requirements

30. Under paragraph 8501(1)(e) of the Regulations, plan texts must be worded so that there is no reason to expect that the PA limits will be exceeded. Plans that provide for money purchase contributions or defined benefit accruals to continue during periods of reduced services need to specify how the rate of remuneration to be used for such periods will be determined. If the remuneration rate used is too high, the resulting PA could be more than the PA limits based partly on prescribed compensation.

Wording of money purchase provisions

31. If a money purchase provision provides for contributions during qualifying periods (see 9 above), it should be clear from the plan wording that the following conditions are met:

- The period is treated differently from regular periods of employment under the plan terms.
- Contributions are related to the member's earnings and the earnings on which contributions will be based for the period are not more than the earnings which the member would have received had it been a regular period of employment.

- The amount of remuneration to be added to actual earnings for contribution purposes during qualifying periods is not more than five years of full-time remuneration for all employers who participate in the RPP and all RPPs of employers who do not deal at arm's length with the member's employer. No more than three more years of full-time remuneration are provided for periods of parenting.

Alternatively, it may be enough for the plan wording to state that the PA limits will not be exceeded for such periods, or that the limits of Section 8507 of the Regulations will not be violated.

If a money purchase provision provides for contributions during periods of disability, the plan wording will not need to show that the PA limits are respected for such periods as long as the first two above-mentioned conditions are met.

Wording of defined benefit provisions

32. A defined benefit provision that provides for accruals during periods which are not regular periods of employment must restrict the periods to those that are eligible service as stated in paragraph 8503(3)(a) of the Regulations. This means the member must be:

- employed in Canada by, and receiving remuneration from, an employer who participates in the plan;
- on an eligible period of temporary absence as defined in subsection 8500(1) of the Regulations; or
- on a period of disability as defined in subsection 8500(1) of the Regulations.

The plan must also state what earnings base will be used for defined benefit accruals during periods that are not regular periods of employment.

It will not be necessary for the plan text to show that the PA limits will be respected for periods which are not regular periods of employment if the plan wording:

- bases earnings for such periods on a rate of pay that is not more than the remuneration which it is reasonable to expect the member would have earned during a regular period of employment;
- restricts the periods that are not regular periods of employment to periods of disability and qualifying periods (that is, periods of reduced pay or temporary absence which meet all of the conditions necessary to be qualifying periods);
- restricts the amount of full-time remuneration to be added to the earnings base for accruals during qualifying periods to five years for all participating employers and RPPs of non-arm's length employers, if any; and
- restricts the amount of additional full-time remuneration to be added to the earnings base for accruals during periods of parenting to three years for all participating

employers and RPPs of non-arm's length employers, if any.

If the plan provides for defined benefit accruals during periods of reduced pay or temporary absence and the above conditions are not met, it must be clear from the plan wording that the PA limits will not be exceeded as a result. Alternatively, it will be enough to state that the limits of Section 8507 of the Regulations will not be violated.

GLOSSARY

In this glossary we give general definitions for some of the terms we use in this circular. For precise meanings for RPP purposes, see the definitions in the *Income Tax Act* and the *Income Tax Regulations*.

Arm's length – We consider that persons who are related to each other will not deal with each other at arm's length. It is a question of fact whether non-related persons deal with each other at arm's length. Subsection 251(1) states when persons are considered not to deal with each other at arm's length. Persons who are related to each other by blood, marriage, or adoption are considered not to deal with each other at arm's length. It is also possible for non-related persons to be considered not to deal with each other at arm's length under certain circumstances. Interpretation Bulletin IT-419, *Meaning of Arm's Length*, gives more information and is available at all of our tax services offices.

Connected with the employer – Subsection 8500(3) of the Regulations contains the rules that determine if a person is connected with an employer for RPP purposes. Generally, a person is connected with an employer at any time if the person:

- owns directly or indirectly 10% or more of the issued shares of any class of the capital stock of the employer or of any other corporation that is related to the employer;
- does not deal at arm's length with the employer; or
- is a specified shareholder of the employer under paragraph (d) of the definition of specified shareholder in subsection 248(1).

Under certain circumstances set out in subsection 8500(3) of the Regulations, we consider a person to own shares of a corporation for the purpose of determining whether the person is connected with an employer.

Deferred profit sharing plan (DPSP) – This is a type of employer-sponsored savings plan we register under section 147. The employer contributions are based on profits.

Defined benefit limit – The defined benefit limit for a calendar year, defined in subsection 8500(1), is the greater of:

- \$1,722.22; and
- 1/9 of the money purchase limit.

Defined benefit provision – A defined benefit provision is defined in subsection 147.1(1). A defined benefit provision of a pension plan gives benefits that are determined according to a formula and do not depend directly on contributions made in a particular year. Typically, defined benefit formulas are based on each member's earnings and years of pensionable service. The employer contributes based on actuarial calculations to ensure the plan benefits are given to the members.

Downsizing – Downsizing occurs when an employer reduces the size of the employer's workforce. An approved downsizing program means a program that the Minister of National Revenue has approved under subsection 8505 of the Regulations, and which offers special benefits to employees who are terminating employment.

Forfeited amount – A forfeited amount (also known as a forfeiture) is an amount under a money purchase provision to which a member has stopped having any rights, other than an amount that is payable as a consequence of death or marriage breakdown. Forfeitures usually result from a member terminating employment without fully vested rights to the employer contributions made for them. Forfeited amount is defined in subsection 8500(1) of the Regulations.

Money purchase provision – This is a provision of a pension plan where benefits are based directly on the amount of contributions made for the employee plus associated investment earnings. At retirement, a money purchase provision gives each member the level of pension income the member's account will buy. Pension plans that contain only money purchase provisions are known as money purchase plans or defined contribution plans. Money purchase provision is defined in subsection 147.1(1).

Participating employer – A participating employer is one who has made or has to make contributions to the plan for the employer's employees or former employees or payments under the plan to the employer's employees or former employees. It is defined in subsection 147.1(1).

Period of reduced services – Period of reduced services is defined in subsection 8300(1) of the Regulations. A period of reduced services is an eligible period of reduced pay, an eligible period of temporary absence, or a period of disability of a member of an RPP.

Specified multi-employer plan (SMEP) – Generally, a SMEP is an RPP that is established under a collective bargaining agreement where employers contribute according to a negotiated contribution formula by reference to the hours worked by employees or some other employee-specific measure. Typically, they are established for persons employed in an industry or trade where there is frequent movement of employees among non-related employers. SMEP is defined in subsection 8510(2) of the Regulations.

Surplus in money purchase provision – A surplus is an amount that has not, at a particular time, been allocated to members in a money purchase provision. Surplus generally exists in a money purchase provision because the money purchase provision has replaced a defined benefit provision

that was in a surplus position. Surplus in a money purchase provision is defined in subsection 8500(1) of the Regulations.

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