Res
HD7105.45
C2C362
1989b

Pension Reform: Improvements in Tax Assistance for Retirement Saving

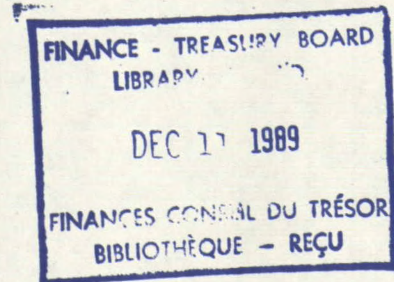
December 1989

Canada

Res
HD7105.45
C2C362
1989b

Pension Reform: Improvements in Tax Assistance for Retirement Saving

December 1989



Department of Finance Canada
Ministère des Finances Canada

Table of Contents

1. Introduction 1

2. How Tax Assistance Works 3

3. A Target Pension 5

4. Tax Assistance Limits Today 6

   Registered Pension Plans 6
   Deferred Profit Sharing Plans 7
   Registered Retirement Saving Plans 7

5. Shortcomings of the System 8

   Unfairness 8
   Inflexibility 14
   Excesses 14

6. The Proposed Limits on Tax-Assisted Saving 16

   Fairness 16
   Flexibility 19
   Cost Control 21

7. Effects of the Proposal 22

   Benefits to Taxpayers 22
   Effect on Government Revenues 23
   Effect on Employers 24
   Effect on Pension Design 25

Notes 26

1. Introduction

To improve opportunities for Canadians to save for their retirement years, the government is undertaking a comprehensive reform of the rules governing tax assistance for saving in pension and retirement savings plans.

Tax assistance for retirement saving is based on a simple principle: within clear limits, income set aside for retirement should be taxed not when it is saved, but when it is received as a pension. By allowing taxpayers to defer tax on savings, and on the growth in those savings in the years before retirement, the tax system encourages and assists Canadians to arrange for their financial security in later years.

The existing system of limits on tax-assisted saving, largely unchanged since 1976, is seriously flawed. Serious inequities in the system leave taxpayers at the same income level with quite different opportunities to save for retirement. For example, widely varying limits apply to saving in different types of plans. Furthermore, taxpayers generally have little opportunity to make up for low contribution or benefit levels in employer-sponsored plans. At the same time, the limits are vulnerable to a growing number of tax planning arrangements that add to tax assistance costs. As a result, many Canadians are denied adequate opportunities to build tax-assisted pensions while others can obtain excessive tax benefits.

Under the proposed system of limits, most Canadians will have increased opportunities to save on a tax-assisted basis. The proposed system sets fairer, clearer and more consistent limits on tax assistance for retirement saving. It will provide Canadians with better opportunities to achieve income security in retirement.

The proposal would mean that all Canadians will have full access to the new limits, regardless of their employment situations or the nature of their savings arrangements. Individuals will no longer lose the right to tax assistance if they are unable to contribute in a year. They will be able to make catch-up contributions in future years when they are better able to afford to save for their retirement.

To increase fairness, and to finance improved opportunities for retirement saving, the reform proposes stricter limits on tax-assistance for high-income earners and eliminates existing opportunities for excessive tax deferrals. The revenue savings from these cost control measures are expected to roughly balance the costs of providing fairer and more flexible limits on tax-assisted saving. Thus, the proposed reform redirects government support for retirement saving to better focus it on the objective of assisting Canadians to obtain a target level of pension income.

The principal features of the proposed reform are:

- a uniform limit of 18 per cent of earnings that applies comprehensively to tax-assisted saving in employer-sponsored registered pension plans (RPPs) and deferred profit sharing plans (DPSPs), and in individual registered retirement savings plans (RRSPs);
- an RRSP limit that allows individuals to use RRSP contributions to supplement saving in their employer-sponsored plans up to the 18-per-cent limit;
- a seven-year carry-forward of unused RRSP contribution room to give individuals more flexibility in saving for their retirement;
- higher dollar limits on contributions to money purchase RPPs, DPSPs and RRSPs to bring them into line with the contribution levels needed to fund the maximum pension benefits currently allowed in defined benefit RPPs;
- deferral to 1995 of any increase in the existing dollar limit on defined benefit pensions, in order to limit tax-assistance to high-income individuals;
- codification in the *Income Tax Act* of the existing registration rules for pension plans to ensure their uniform application; and
- measures to increase fairness and produce cost savings by eliminating existing opportunities for excess tax deferrals that mainly benefit high-income earners.

The proposed improvements meet an urgent need. In less than 20 years, the children of the baby boom will begin to reach

retirement age. In 40 years, nearly 30 per cent of Canada's adult population will be over age 65, compared with less than 15 per cent today. A sound tax framework is needed to encourage the increased private saving that is required now to meet pension needs later. The proposed changes satisfy this need by removing barriers that prevent many individuals from achieving adequate levels of tax-assisted saving and by placing more consistent and effective limits on saving that qualifies for tax assistance.

This reform complements measures the government has already taken to strengthen Canada's retirement income system. These include improvement of benefits provided under the Canada Pension Plan (CPP) and the Spouse's Allowance program and changes in contribution rates to make the financing of the CPP more secure. They also include important improvements in minimum standards for benefits under private pension plans – such as earlier vesting of employer contributions in the employee, improved portability options, and improved survivor benefits for the spouses of plan members.

The proposed legislation has been prepared in extensive consultation with representatives of business, labour, the pension industry, and Canadians at large, based on the original proposals set out in a paper released on October 9, 1986 and detailed draft legislation released on March 28, 1988.

This publication outlines the shortcomings of the present system of tax assistance for retirement saving, summarizes the proposed changes, and shows how they will affect individual taxpayers. A more detailed description of the changes can be found in the document *Saving for Retirement: A Guide to the Tax Legislation and Regulations.*

2. How Tax Assistance Works

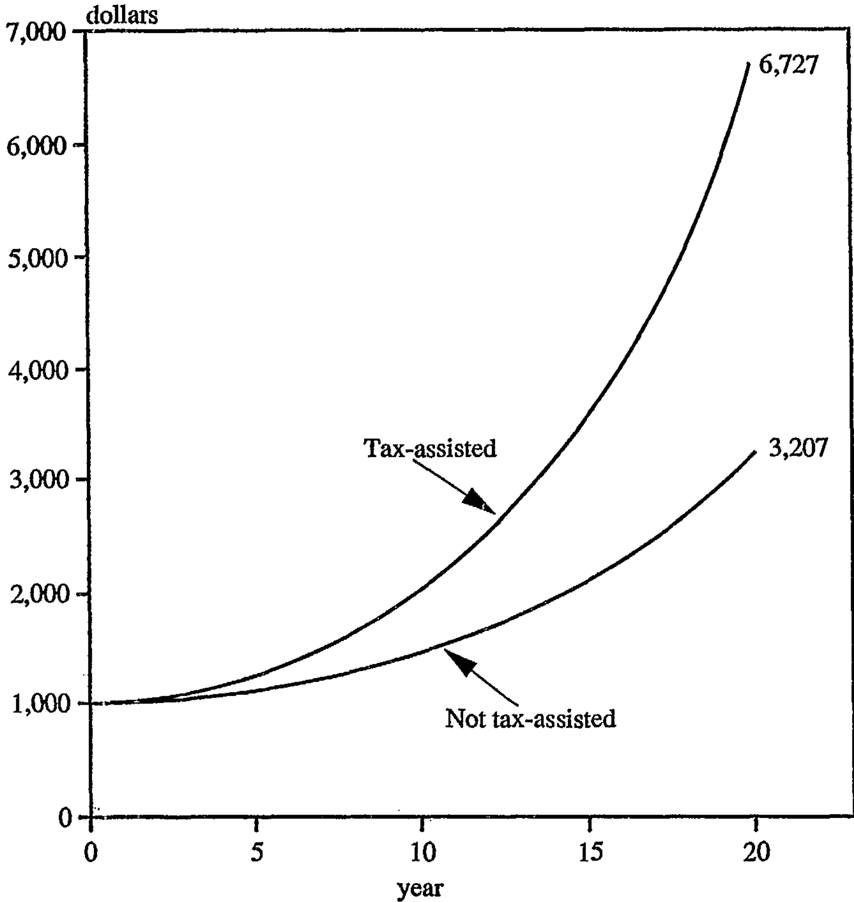
The tax treatment of retirement saving is based on the principle that, within limits, income set aside for retirement should be taxed when it is received as a pension, not when it is saved. This tax deferral provides significant benefits to savers.

To achieve this result, contributions to registered plans by both employers and employees are tax deductible, and investment earnings

Chart 1

The Value of Tax-Assisted Retirement Saving

After-Tax Value of $1,000 of Saving



Assumptions:

(1) Pre-tax investment return of 10 per cent.

(2) Combined federal-provincial tax rate of 40 per cent.

in the plans are tax exempt. Withdrawals from registered plans are taxable. In this way, the tax on income contributed to, and earned in, registered plans is deferred until benefits are actually paid out.

This tax deferral significantly increases the benefit of saving in registered pension or retirement saving plans rather than in non tax-sheltered vehicles. For example, over 20 years, $1,000 of savings can grow in a registered plan to an after-tax amount of $6,727, more than double the $3,207 it would reach outside a registered plan (see Chart 1).

The benefits to savers have large revenue costs to government. Taking into account the total amount of income currently sheltered in RPPs, DPSPs and RRSPs, the tax deferrals are estimated to cost $5 to $6 billion per year in foregone federal tax revenues, and $8 to $9 billion when provincial revenue costs are included.

3. A Target Pension

Government policy on retirement income has two basic objectives:

- to guarantee a basic level of income for all elderly Canadians; and
- to enable Canadians to avoid serious disruption of their living standards upon retirement.

A basic income is provided through the Old Age Security program, the Guaranteed Income Supplement, and the Spouse's Allowance. In addition, a basic level of earnings replacement is provided under the Canada and Quebec Pension Plans.

Employer-sponsored pension plans and individual retirement savings plans are the other key components of the retirement income system. By regulating these plans and providing tax assistance to them, the government helps taxpayers build adequate retirement incomes.

To maintain living standards, individuals need to replace income sources that cease at retirement, chiefly earnings from employment or self-employment. Earnings do not need to be fully replaced, however, since work-related expenses, income taxes and savings requirements typically decline at retirement. A pension of between

60 and 70 per cent of pre-retirement earnings is generally considered to be sufficient to avoid serious disruption of living standards.

The adequacy of existing limits on benefits and contributions can thus be judged by whether they are high enough and flexible enough to permit individuals to attain a target pension of 60 to 70 per cent of pre-retirement earnings after a full career of saving.

However, to limit the cost of the tax assistance provided to higher-income individuals, full tax assistance for a 60- to 70-per-cent pension should only apply up to some ceiling level of earnings. Accordingly, the benefit and contribution levels should be subject to dollar maximums.

4. Tax-Assistance Limits Today

The existing system of tax-assistance limits applies differently to registered pension plans (RPPs), deferred profit sharing plans (DPSPs), and registered retirement savings plans (RRSPs).

Registered Pension Plans

RPPs are employer-sponsored or union-sponsored arrangements for retirement income. They can be funded by contributions from employers alone (non-contributory plans), or from both employers and employees (contributory plans).

There are two types of RPP: **money purchase** and **defined benefit.**

Money Purchase RPPs do not set a prospective level of retirement income. Rather, they provide whatever pension income the accumulated contributions and return on investment in the plan will purchase at retirement.

Defined Benefit RPPs differ from money purchase RPPs by setting a prospective level of retirement income: the 'defined benefit'. Over 90 per cent of all RPP members belong to defined benefit plans.

The limits on tax assistance for the two types of plan reflect the basic difference between them. Money purchase plans are subject to annual

limits on employer and employee contributions to them, but no limit on the benefits they may provide. In contrast, defined benefit plans are subject to a limit on the pension benefits they may provide but are **not** subject to fixed limits on annual contributions.

For money purchase plans, the maximum tax-deductible contributions on behalf of each employee are $3,500 from the employer and $3,500 from the employee, for a total contribution limit of $7,000.

For defined benefit plans, benefits are limited to 2 per cent of an average of the best three years' earnings, to a dollar maximum of $1,715, for each year of service up to 35 years. The maximum pension eligible for tax assistance under a defined benefit plan is therefore $60,025 ($1,715 x 35 years). There are no fixed limits on employer or employee contributions. However, deductible employer contributions are limited to the amounts necessary to provide for full funding of the promised benefits.

Deferred Profit Sharing Plans

DPSPs are employer-sponsored deferred income plans under which contributions are often related to company profit levels. Employer contributions are deductible up to a maximum of $3,500 per employee less any employer RPP contribution on behalf of the employee. The existing rules also permit non-deductible contributions by both employers and employees.

Registered Retirement Savings Plans

RRSPs are individual rather than employer-sponsored saving plans. The deduction limit on annual contributions is 20 per cent of earned income up to:

- $7,500, for taxpayers not belonging to an RPP or DPSP; or
- $3,500 less employee RPP contributions, for other taxpayers.

The limit on RRSP contributions by an RPP member depends on the employee's RPP contribution only; it is not related to the level of employer RPP contributions or the level of RPP benefits.

A taxpayer can save for retirement through more than one type of registered plan. Some employers supplement defined benefit pension plans with DPSP contributions. Saving through RPPs and DPSPs is often supplemented by individual RRSP contributions.

5. Shortcomings of the System

Major reform of the existing system of limits is essential to rectify the following shortcomings:

- **unfairness:** taxpayers in different employment situations receive different levels of tax assistance;
- **inflexibility:** most taxpayers have no opportunity to make up for low saving levels in years past; and
- **excesses:** poorly structured limits allow some high-income taxpayers to obtain unintended levels of assistance.

The objectives of reform are to permit Canadians to reach target pension levels with fairer and more flexible tax assistance, and, by eliminating unintended tax-deferral opportunities, to improve control over tax-assistance costs. The main problems with the existing system of limits are elaborated below.

Unfairness

Taxpayers in different employment situations do not have the same access to tax-assisted retirement savings. These disparities arise because:

- the effective limit on tax-assisted saving varies widely from one type of plan to another; and
- even within types of employer-sponsored plans, the generosity of defined benefits or employer contributions can vary widely.

Varying Limits by Type of Plan

Many of the disparities in the limits stem from the fact that the contribution limits for money purchase plans are not consistent with the benefit limits applicable to defined benefit plans.

Actuaries estimate that, on average, over a 35-year working career, it is necessary to save $900 per year of employment in order to purchase a pension in retirement of $100 for each year of service. (For information about this estimate, see Note 1 on page 26.) This 9:1 ratio of contributions to benefits means that it is necessary to save 18 per cent of earnings in order to fund a pension equal to 2 per cent of pre-retirement earnings for each year of service. Similarly, the benefit limit of $1,715 per year of service in a defined benefit pension plan is consistent with an annual contribution limit of $15,500 (= 9 × $1,715, rounded). This is more than double the existing $7,000 limit on contributions to money purchase RPPs. In other words, those who belong to defined benefit RPPs can generate retirement incomes twice as high as those saving only in RRSPs.

Based on this relationship between contribution and benefit levels, Table 1 provides a summary, in constant 1989 dollars, of the effective limits on contributions and benefits for members of different types of plans.

RRSP-only. Taxpayers who are not members of pension plans and save for retirement through RRSPs alone can contribute only up to $7,500 each year. Over 35 years, this maximum will provide for a pension of about $29,000 a year. Taxpayers with incomes higher than $41,700 will therefore not be able to reach the target pension of 70 per cent of earnings after a 35-year career.

DPSP and RRSP; Money Purchase RPP. The effective contribution limit of $7,000 for members of money purchase RPPs limits the expected pension after 35 years to only $27,000. The same is true for members of DPSPs who supplement the maximum $3,500 employer contribution with an RRSP contribution of an equal amount. Members of money purchase plans or DPSPs earning more than $38,900 cannot build the target pension.

Defined Benefit RPP. Members of generous defined benefit plans receive much more favourable treatment. The maximum pension of $1,715 for each year of service ($60,025 for 35 years) requires annual average contributions (employer plus employee) of about $15,500, much higher than the maximum contribution for other plans. Moreover, because some plans require no employee contribution, or only a small employee contribution, members of defined benefit plans

Table 1

Effective Contribution and Pension Limits for Different Types of Plans

	Effective maximum annual contribution (employee and employer)	Effective maximum annual pension after 35 years	Income level at which maximum contribution represents 18 per cent of earnings
		(dollars)	
RRSP only	7,500*	29,000	41,700
DPSP + RRSP	7,000*	27,000	38,900
Money purchase RPP	7,000*	27,000	38,900
Defined benefit RPP			
• With employee contribution (no RRSP)	15,500	60,000*	86,100
• Without employee contribution (with RRSP)	19,000	73,000	105,600

Note: Limits set in the *Income Tax Act* or Revenue Canada's pension plan registration rules are marked with an asterisk (*). The other limits are based on the estimated average annual contribution cost of $9 for each $1 of annual pension income.

often have unused RRSP room they can use to increase retirement income above 2 per cent of earnings for each year of service. Taxpayers who belong to plans with maximum defined benefits and no employee contribution can supplement their pension saving with RRSP contributions of $3,500 a year and so achieve total effective contribution levels of $19,000 a year. This could provide them with pensions of $73,000 after 35 years. The target pension can be reached on a fully tax-assisted basis by members of such plans with earnings up to $105,600.

Chart 2 below provides an additional illustration of the inequity of the existing tax assistance limits for members of different types of

plans. For a taxpayer earning $55,000, the effective limit ranges upward from 12.7 per cent of earnings, if the taxpayer belongs to a money purchase RPP or to a DPSP (example 2), to 23.3 per cent of earnings, if the taxpayer belongs to a non-contributory, 2-per-cent defined benefit plan (example 4). The taxpayer is able to build the target pension – or indeed a higher pension – only if he or she belongs to a relatively generous defined benefit plan (examples 3 and 4).

Varying Levels of Employer-Provided Benefits

Access to tax assistance also varies widely among taxpayers because of variations in the level of contributions or benefits provided by employers. For employees who belong to an RPP or DPSP, the additional contributions they can make to an RRSP depend only on the amount of their employee pension contributions – and not on the amount of employer contributions to, or defined benefits promised under, the RPP or DPSP. This means that they often cannot contribute enough to an RRSP to compensate for low benefits under an employer-sponsored plan.

Low contributions or benefits from employers can take many forms:

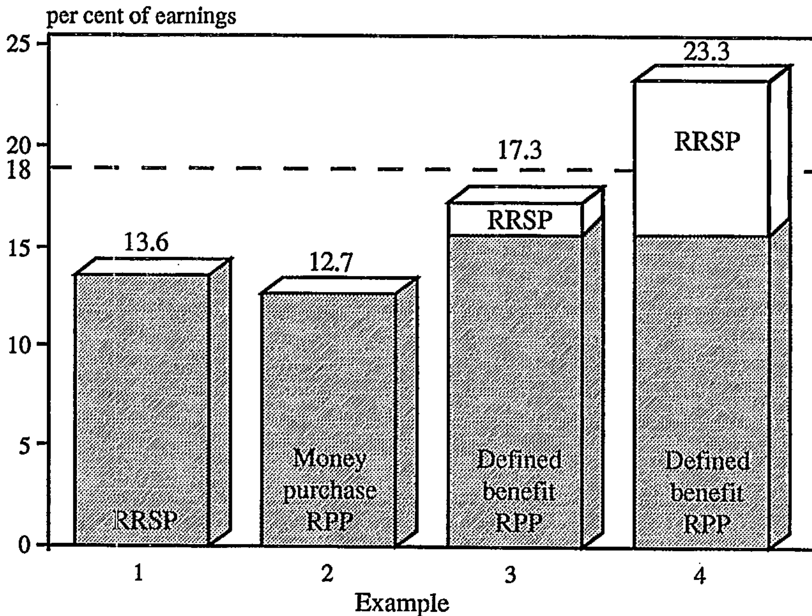
- a low employer contribution rate of, say, 3 per cent of pay in a money purchase RPP;
- a low DPSP contribution in a year of low profits;
- a low benefit rate in a defined benefit plan;
- a defined benefit plan based on only part of an employee's total earnings (for example, because components like overtime are not pensionable, or because the employee has earnings from self-employment or other employment); and
- a contribution or benefit based on membership in an employer-sponsored plan for only part of a year.

Many taxpayers are unable to reach the effective saving limits illustrated in Chart 2 because of such problems. Chart 3 provides four more examples in which the level of contributions or benefits provided by the taxpayer's employer affects tax assistance to the employee.

Chart 2

Varying Limits on Tax-Assisted Saving by Type of Plan

Effective Contribution Limit as a Per Cent of Earnings for a Taxpayer Earning $55,000



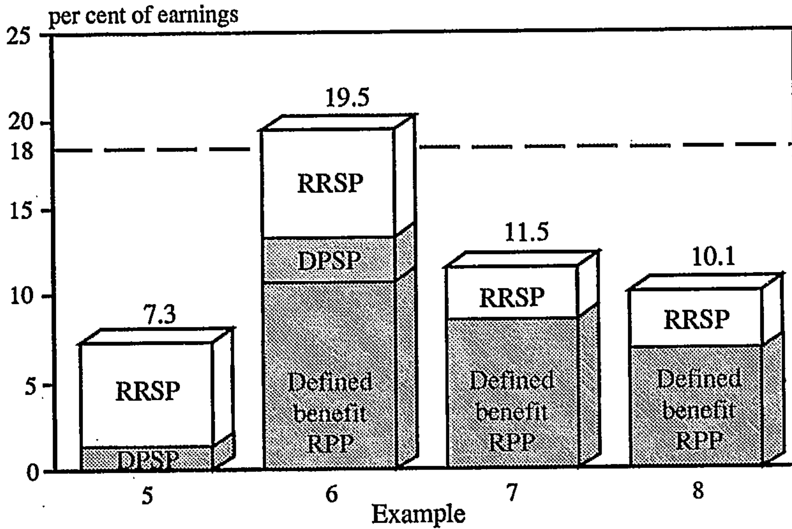
1 RRSP only
2 Money purchase RPP or DPSP plus RRSP
3 2 per cent defined benefit RPP plus RRSP
  - RPP benefits not reduced by CPP/QPP benefits
  - 6 per cent employee contribution rate
4 2 per cent defined benefit RPP plus RRSP
  - RPP benefits not reduced by CPP/QPP benefits
  - No employee contribution to RPP

Note: For defined benefit RPPs (3 and 4), the effective contributions are determined as (9 x benefit rate x earnings) minus $600. The allowance of $600 reflects a possible shortfall of benefit quality from the standard pension on which the 9:1 ratio was based, owing to such factors as the level of inflation adjustments and survivor benefits.

Chart 3

Varying Limits on Tax-Assisted Saving by Generosity of Employer-Sponsored Arrangements

Effective Contribution Limit as a Per Cent of Earnings for a Taxpayer Earning $55,000



5 $500 DPSP contribution by employer

6 1.75 per cent defined benefit RPP plus $1,000 DPSP contribution
- RPP benefits reduced by CPP/QPP benefits
- No employee contribution

7 1.5 per cent defined benefit RPP
- Reduced by CPP/QPP benefits
- 4 per cent employee contribution rate

8 1.75 per cent defined benefit RPP
- Reduced by CPP/QPP benefits
- 4.5 per cent employee contribution rate
- Only $40,000 of earnings pensionable

Note: For defined benefit RPPs (examples 6, 7 and 8), the effective contributions are determined as 9 x (benefit rate x earnings – CPP/QPP offset) minus $600.

The examples are again based on earnings of $55,000. In example 5, the employer contributes $500 to an employee's DPSP. With the $3,500 RRSP limit, this limits the taxpayer's tax-assisted saving to $4,000 or 7.3 per cent of earnings. In example 6, the taxpayer belongs to a 1.75-per-cent 'integrated', non-contributory defined benefit plan, in which benefits are reduced by the amount of CPP or QPP benefits. In addition, the employer contributes $1,000 to a DPSP for the taxpayer. (As most defined benefit plans are integrated with the CPP or QPP, this example is more representative than example 3 in Chart 1.) Example 7 illustrates the lower tax-assistance limit of 11 per cent of earnings that applies to a taxpayer in a 1.5-per-cent, contributory plan where benefits are integrated with CPP or QPP benefits. Finally, example 8 shows the situation of a member of a 1.75-per-cent, contributory integrated plan that excludes a significant portion of earnings ($15,000 out of $55,000) from pensionable earnings.

Inflexibility

The annual limits on tax-assisted saving do not permit employees in most cases to make up for missed savings opportunities. Members of some defined benefit RPPs can obtain benefits for past service, but taxpayers saving through money purchase RPPs, DPSPs, or RRSPs cannot contribute for years of past service in which they or their employers did not contribute. Also, the limits do not permit employees to make up for the loss of pension benefits that often occurs on job termination.

Excesses

The present rules have enabled some individuals to reach unintended levels of tax assistance in various ways. For example:

- The maximum pension rules are administrative rules that are set out in a Revenue Canada Information Circular rather than being codified in the *Income Tax Act*. They have not been applied uniformly. For example, some registered plans have been permitted to provide benefits above 2 per cent of earnings for each year of service, and a larger number have provided annual

accruals above $1,715. Similar exceptions have been made to the limits on other plan features, such as benefit levels for early retirees. As each exception has led to pressure for more, difficulties in applying the limits have snowballed.

- The rules permit the purchase of past service credits under defined benefit plans for years in which maximum RRSP contributions were already made. This has permitted taxpayers to double up on the intended limits on tax-assisted saving.

- Additional voluntary contributions (AVCs) to money purchase accounts of pension plans have been permitted for years of past service even when full RRSP contributions had been made, or pension benefits had been earned, during those years. Again, this has permitted a doubling up of tax assistance.

- Extra non-deductible contributions to DPSPs and RRSPs are permitted, in addition to deductible contributions within the limits. They increase the level of assets that generates tax-free investment income.

- Tax-free transfers of periodic pension income to RRSPs are permitted. This allows taxpayers who can afford it to defer receiving special early retirement benefits and other pension benefits and so generate additional tax assistance.

- The tax rules governing employee benefit plans (EBPs) have permitted public sector employees and other employees of non-taxable employers to obtain the same tax deferral advantages as are available for saving in registered plans. For example, an employee could arrange for his or her employer to make a $10,000 EBP contribution, financed by a cut in current salary of the same amount. The effect of the $10,000 salary cut on the employee's tax position would be the same as if the contribution was made by the employee on a tax-deductible basis. Tax on the investment earnings on EBP funds could also be deferred by having the earnings paid out to the employer each year, taxed in the employer's hands, and then recontributed to the plan. In this way, public sector and other employees have been able to defer tax on virtually unlimited amounts of current earnings in addition to their saving in registered plans.

These unintended tax deferrals are contributing to the large and growing revenue costs of tax assistance and to the increasing inequity of the rules. They provide evidence that the existing seriously flawed system of limits needs to be replaced by a system that is fairer and that provides a better basis for controlling tax-assistance costs.

6. The Proposed Limits on Tax-Assisted Saving

The proposed system of limits provides fairer access to tax assistance, greater flexibility for retirement saving, and improved control over tax-assistance costs. The main features of the system are described below.

Fairness

Fairer access is assured by more uniform application of the pension limits for RPPs, a single limit of 18 per cent of earnings for employer-sponsored and individual saving in all registered plans, and a consistent set of dollar limits on contributions and pension benefits.

Uniform Application of Pension Limits

The proposed system is based on the existing defined benefit pension limit of 2 per cent of earnings per year of service, permitting build-up of the target pension of 60 to 70 per cent of pre-retirement earnings over the course of a career of 30 to 35 years.

The proposed legislation also codifies many of Revenue Canada's pension plan registration rules in the *Income Tax Act* to ensure that they are applied uniformly to all plans. These include limits on inflation adjustments, survivor benefits, special early retirement benefits, and periods of eligible service, including periods of credited leave without pay.

The proposed registration requirements are generally based on the existing rules; most pension plans will require little or no substantive change. Where the codified rules would reduce defined benefits in

plans existing before March 28, 1988 (when the rules were announced), these will apply only after 1991 and only to benefits earned after 1991. This will give time for necessary amendments and ensure that no benefit restrictions apply retroactively.

Comprehensive Limit on Tax-Assisted Saving

A comprehensive limit of 18 per cent of earnings on tax-assisted saving is central to the proposed system. The limit has three important features.

First, it is consistent with the maximum pension limit. It represents the required annual contribution expected to fund, over a full career, a pension of 2 per cent for each year of service.

Second, the proposed limit applies to all saving, through both employer and employee contributions, and in all three types of registered plan – RPPs, DPSPs and RRSPs. The limit applies evenly to saving in defined benefit and money purchase plans. It also applies uniformly to a single plan or a combination of plans.

Third, the proposed tax assistance limit is no longer dependent on the generosity of an individual's employer-sponsored plans. All taxpayers have full access to the 18-per-cent limit. This is achieved by defining each taxpayer's annual RRSP limit as the difference between 18 per cent of earnings and the level of saving in the year in employer-sponsored plans.

How the Proposed Limit Works

Basing an individual's RRSP limit on saving in employer-sponsored plans requires a way of measuring annual saving that works for both money purchase and defined benefit plans. For money purchase plans, the sum of employer and employee contributions by or for the individual in the year is the obvious measure. For defined benefit plans, however, the total annual contribution by or for the individual is not an appropriate measure since employer contributions to fund a given level of benefits can vary widely from plan to plan and from year to year depending on the plan's investment performance and the employer's current financial priorities. RRSP limits based on such a measure would be erratic and unfair.

To overcome this problem, a better measure of saving in defined benefit plans has been devised. It is known as the 'pension adjustment' (PA). For defined benefit plans, the PA is determined by translating the benefits earned in the year into contribution terms using the standard contribution-to-pension ratio of 9:1. (For further details concerning the determination of PAs, see Note 2 on page 26.) A PA is also determined for saving in money purchase plans. For these plans, it is simply the sum of employer and employee contributions by or for the individual in the year.

Where an employee earns benefits or is credited with contributions under more than one plan of an employer, the PA will be the sum of the PAs for each plan. Plan sponsors will be required to ensure that benefits and contributions under their plans are limited so that an 18-per-cent limit on the PA of each employee is respected.

Employers who sponsor RPPs or DPSPs will be required to report a PA for each plan member each year as part of the T4 reporting process. The first report is due by the end of February 1991, based on pension and DPSP accruals in 1990.

To ensure that everyone has access to the full tax-assistance limit, each taxpayer's RRSP limit for a year will be determined as 18 per cent of earned income for the previous year less the PA reported for that year. The one-year lag in the RRSP limit will permit Revenue Canada to issue individual statements to pension plan members informing them of their RRSP limits calculated from earnings and PAs for the preceding year. The first such statement will be issued towards the end of 1991; as at present, taxpayers will have until 60 days after the end of 1991 to make RRSP contributions for that year. Under the new system, most taxpayers will know their RRSP limits earlier in the year than they do now.

Consistent Dollar Limits on Benefits and Contributions

The current maximum pension of $1,715 per year of service permits a 2-per-cent pension to be paid on earnings of up to $85,750 – more than three times the average wage. The proposed limit will lower the maximum level of covered earnings to about two-and-a-half times the average wage. This will limit the cost of tax assistance in order to

permit improvements giving more Canadians the opportunity to build adequate pensions. The maximum will be effectively reduced by delaying until 1995 any increase in the maximum pension limit to reflect the growth in wages and prices. Beginning in 1995, the limit will be increased in line with increases in the average industrial wage in the same way as pensionable earnings are now adjusted under the Canada and Quebec Pension Plans.

The present money purchase and RRSP limits of $7,000 and $7,500 permit full contributions of 18 per cent of earnings on earnings up to about one-and-a-half times the average wage. To bring the limits up to the same level as that required to fund the maximum pension under a defined benefit RPP, it is proposed that they be raised to $15,500 per year, phased in over a period ending in 1994 for employer-sponsored plans and 1995 for RRSPs (see Table 2). Annual adjustments to the contribution limits, beginning in 1995, will parallel the adjustments to the maximum pension.

Flexibility

It is proposed that taxpayers who do not fully use their RRSP contribution limits in a year will be able to carry forward the unused portions for up to seven years. This measure will be of particular benefit to individuals with fluctuating incomes as well as individuals who may find it difficult to contribute in a particular year because they are saving for a house, for example, or are starting a small business. This important innovation will thus enable all taxpayers to vary the pattern of their retirement saving to more closely fit their financial needs. The carry-forward will come into effect in 1992 based on contribution room unused in 1991.

Applying the RRSP contribution limits on a multi-year basis permits the introduction of two adjustments for earlier service that will make the tax-assistance limits fairer and more flexible.

First, a past service pension adjustment (PSPA) will be reported by the plan administrator when past service benefits are provided to an individual. Such benefits can be provided to an RPP member either through a general upgrade in plan benefits or as credits for years of eligible service during which the individual did not belong to the plan.

Table 2

Equalizing Contribution Limits

Year	Employer-sponsored money purchase plans	RRSPs	Defined benefit RPPs*
		(dollars)	
1989	7,000	7,500	15,500
1990	7,000	7,500	15,500
1991	12,500	11,500	15,500
1992	13,500	12,500	15,500
1993	14,500	13,500	15,500
1994	15,500	14,500	15,500
1995	15,500**	15,500	15,500**
1996		15,500**	

* Effective contribution limits obtained by multiplying the maximum pension limit of $1,715 by the standard contribution cost factor of 9.

** Indexed to growth in the average wage.

Since a PSPA will reduce the individual's unused RRSP contribution room, it will ensure that the same earnings cannot be used as the basis for both pension benefits and RRSP contributions. In some cases, the Minister of National Revenue will be required to certify that sufficient unused RRSP room is available before past service benefits may be paid to an individual.

Second, an employee who changes jobs and loses the right to benefits under an employer-sponsored plan can be given higher RRSP limits through the reporting of a pension adjustment reversal (PAR). In general terms, the PAR is the difference between the taxpayer's previously reported PAs and any payment made when the taxpayer terminates membership in an RPP or DPSP before retirement.

Cost Control

The proposal includes a variety of measures to improve control over the costs of tax assistance for retirement saving. Some have already been mentioned in other connections:

- codification of the maximum pension limits and other pension plan registration rules to ensure their uniform application;
- reduction of the high tax assistance levels currently available to individuals saving through certain combinations of plans (for example, RRSPs and DPSPs combined with generous, non-contributory defined benefit RPPs);
- freezing of the dollar limit of $1,715 per year of service on benefits under defined benefit pension plans until 1995 to reduce tax assistance provided to high-income earners; and
- introduction of PSPA reporting to eliminate opportunities to exceed tax assistance limits through the provision of past service credits.

Another measure to increase fairness and control revenue costs is the elimination of deductions for additional voluntary contributions (AVCs) to money purchase accounts of pension plans for years of past service. The existing rules have permitted AVCs for past service regardless of the level of RRSP contributions made or pension benefits earned in the earlier years of service. This measure was announced on October 9, 1986 and was effective from that date.

Changes to the rules applying to DPSPs and RRSPs will eliminate the existing opportunities for taxpayers or their employers to make non-deductible contributions to these plans in addition to deductible contributions.

The proposed reform also includes measures to ensure that the tax-assistance limits are maintained when a taxpayer transfers funds or service credits from one registered plan to another. From 1989, lump-sum transfers of funds are permitted only if made directly from one plan to another. New limits on transfers from defined benefit to money purchase plans will prevent the conversion of actuarial surpluses into pension benefits above the limits. The limits will also

prevent the roll-over of special early retirement benefits into registered plans to obtain tax deferrals higher than the intended limits. Restrictions on tax-free roll-overs of periodic pension income, effective from 1990, will also prevent excess tax deferrals.

Finally, measures have already been implemented under the reform to eliminate the tax deferral advantages formerly available to some taxpayers through employer contributions to unregistered employee benefit plans. The funding of supplementary retirement schemes outside registered plans is subject to the income tax rules regarding retirement compensation arrangements (RCAs). Contributions to an RCA, and earnings within it, are subject to a special refundable tax ensuring that no tax deferral advantages are obtained.

In this connection, it should be emphasized that the proposed reform is not intended to restrict the retirement benefits that may be provided to employees. Its purpose is rather to limit the tax assistance provided in connection with such benefits. Pension benefits higher than the tax assistance maximums may still be provided, either through funded RCAs or on a pay-as-you-go basis. For example, where existing RPPs provide benefits in excess of the limits, the excess benefits will have to be removed from the registered plan as of January 1, 1992. However, the pay-as-you-go or RCA approach may be used as a means of continuing to provide the excess benefits on a non-tax-assisted basis.

7. Effects of the Proposal

The proposed changes to the tax-assistance limits for retirement saving will have broad effects: on retirement saving itself, on government revenues, on employers, and on pension design.

Benefits to Taxpayers

Fairer and more flexible limits on tax-assisted retirement saving will allow more Canadians to achieve the target pensions necessary to ensure income security in retirement.

The diverse limits on saving through different types of plan, illustrated in Chart 2, and the dependence of individual tax-

assistance limits on the generosity of employer-sponsored plans, illustrated in Chart 3, will be replaced by a system that gives each individual access to the uniform tax-assistance limit of 18 per cent of earnings.

The proposed seven-year carry-forward of unused RRSP contribution room, and the restoration of contribution room when benefits are lost on leaving a plan, will give taxpayers more opportunity to take advantage of tax assistance.

The proposed reform should be of particular benefit to:

- self-employed and employed individuals without employer-sponsored plans;
- individuals who earn low pension benefits in a year because:
    - their plan provides low benefits;
    - their plan covers only part of their total earnings; or
    - they belong to a plan for only part of the year.
- individuals who lose benefits when they change jobs or become unemployed;
- all those who cannot take full advantage of their RRSP limits each year because of temporarily low earnings in the year or because of other financial priorities.

Effect on Government Revenues

A comparison of the existing and proposed RRSP limits indicates additional federal revenue costs of $300 million to $350 million for fiscal year 1991-92. However, these will be offset by revenue savings from measures which include:

- stopping unlimited salary deferrals in employee benefit plans;
- eliminating the deductibility of past service AVCs;
- introducing controls over the doubling-up of tax-assistance benefits through past service credits;

- restricting transfers between plans and the roll-over of pension payments into RRSPs; and
- preventing a major increase in RRSP limits through a continuing shift to non-contributory pension plans.

Taking all these measures into account leads to the conclusion that the proposal will not result in any net revenue costs for the federal or provincial governments. Rather, it will redirect existing resources to assist more Canadians to achieve adequate levels of retirement income.

Effect on Employers

Under the proposal, employers who sponsor pension plans or DPSPs will be required to report a pension adjustment (PA) annually for each plan member. In addition, reporting will generally be required where past service credits are granted or an employee leaves a plan.

For money purchase RPPs, certain multi-employer defined benefit RPPs, and DPSPs, the PA is simply the sum of employer and employee contributions.

For defined benefit RPPs, the PA is generally determined directly from the plan benefit rate and the employee's pensionable earnings in the year. This calculation has been designed to be as straightforward as possible. It parallels the calculation now required to determine employee contribution levels for most pension plan members.

The government recognizes that the calculation and reporting of PAs and other amounts will impose a new compliance burden on employers, particularly in the beginning when changes to payroll reporting systems are required and employee inquiries create additional work. Based on expert advice from pension consultants, the Department of Finance estimates that start-up compliance costs for employers in aggregate will be from $60 to $70 million, and later annual reporting costs will be $10 to $15 million.

In view of the importance of retirement income security to Canadians and the level of tax assistance for retirement saving, the government believes that such reporting costs are reasonable. To place them in

perspective, the estimated ongoing costs for employers are about **one-sixth of 1 per cent** of the $8 to $9 billion in annual tax expenditures on the preferential tax treatment of retirement saving.

Effect on Pension Design

Under the proposed system of limits, the choice of pension arrangements by employers should be based less on tax considerations than it is now. The existing uneven limits strongly favour defined benefit RPPs and non-contributory plans. Thus, the introduction of comparable limits on saving in different types of plans may be expected to result in some shift away from defined benefit plans, especially among smaller employers.

The existing RRSP limits are reduced by employee contributions to pension plans. For defined benefit plans, this has created an incentive to reduce or eliminate such contributions. This incentive is removed under the proposed system since the RRSP limits of pension plan members depend only on plan benefit levels and not on the level of employee contributions. This change removes a disincentive to employee funding of the cost of new or existing pension benefits.

While the proposed RRSP limits depend on how high an individual's benefit rate is in a defined benefit pension plan, they do not depend on the level of ancillary benefits (such as indexing and survivor benefits) in the plan. Accordingly, the proposed limits support the policy of this government and provincial governments to encourage the provision of these socially desirable benefits.

The basic effect on pension plan design of the more neutral treatment of plan types and cost-sharing arrangements will be to give employers and employees freedom to choose retirement saving arrangements more attuned to their own particular needs.

Notes

1. Factor of 9

The contribution-to-benefit ratio of 9:1 is based on the following assumptions:

(i) Maximum contributions are made each year for 35 years;

(ii) The contribution and pension limits maintain their current relationship with the average industrial wage;

(iii) Investment returns are 2 per cent per year more than the rate of increase in the average industrial wage;

(iv) The pension starts at age 63;

(v) The pension is indexed, once it starts, to the rate of increase in the Consumer Price Index minus 1 per cent; and

(vi) The pension includes a survivor benefit of 60 per cent of the base pension.

2. PA formula for a Defined Benefit Plan

The actual pension adjustment (PA) formula for a defined benefit plan is (9 x (benefit entitlement)) minus $600. The allowance of $600 is an ad hoc adjustment for shortfalls in pension quality (level of indexing, for example) from that assumed in deriving the conversion factor of 9.

For a 'flat benefit' plan, where the promised benefit is $20 per month or $240 per year for each year of service, for example, the benefit entitlement is simply $240.

For an earnings-related plan, in which benefits are determined as 2 per cent of some average of pensionable earnings, for example, the benefit entitlement is 2 per cent of pensionable earnings in the year.

In plans integrated with the CPP or QPP, a lower rate of benefits generally applies on earnings up to the Year's Maximum Pensionable Earnings (YMPE) under the CPP and QPP. A typical calculation of the benefit entitlement for someone with earnings above the YMPE in a 2-per-cent, integrated plan would be (2 per cent of total pensionable earnings) less (0.7 per cent of the YMPE).