MORNEAU SOBECO

14th Edition

Morneau Sobeco Handbook of Canadian Pension and Benefit Plans

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FOREWORD

This book is the result of the efforts of the following professionals at Morneau Sobeco who assisted in the revision of the 14th Edition:

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Lois C. Gottlieb and B. Bethune A. Whiston, Co-ordinators

June 2008

LIST OF ACRONYMS

The following acronyms are used in this publication:

ACPM	Association of Canadian Pension Management
AcSB	Accounting Standards Board
AD&D	Accidental Death and Dismemberment
AIR	Annual Information Return
ASO	Administrative Services Only
ASP	Application Service Provider
AWI	Average Weekly Income
BPO	Business Process Outsourcing
CANSIM	Canadian Socio-economic Information Management database. Statistics Canada, the Bank of Canada and Canada Mortgage and Housing Corporation maintain information contained in this database.
CAP	Capital Accumulation Plan
CAPSA	Canadian Association of Pension Supervisory Authorities
CEIC	Canada Employment Insurance Commission
CFR	Claims Fluctuation Reserve
CHST	Canada Health and Social Transfer
CIA	Canadian Institute of Actuaries
CICA	Canadian Institute of Chartered Accountants
CLHIA	Canadian Life and Health Insurance Association
COB	Coordination of Benefits
CPI	Consumer Price Index
CPP	Canada Pension Plan
CRA	Canada Revenue Agency (With the reallocation of the Customs branch, the CCRA became the CRA.)
CSA	Canadian Securities Administration
DB	Defined Benefit
DC	Defined Contribution
DLR	Disabled Life Reserves
DPSP	Deferred Profit Sharing Plan

DSU	Deferred Share Unit
EAP	Employee Assistance Program
EFAP	Employee and Family Assistance Program
EDI	Electronic Data Interchange
EHC	Extended Health Care
EI	Employment Insurance
EPSP	Employees Profit Sharing Plan
ERISA	*Employee Retirement Income Security Act of 1974* (U.S.)
ESG	Environmental, Social and Governance
FAQ	Frequently Asked Questions
FASB	Financial Accounting Standards Board (U.S.)
FPP	Flexible Pension Plan
FPR	Foreign Property Rule
FSCO	Financial Services Commission of Ontario
GAINS	Guaranteed Annual Income System (Ontario)
GDP	Gross Domestic Product
GIC	Guaranteed Investment Certificate
GIS	Guaranteed Income Supplement
GST	General Sales Tax
HCSA	Health Care Spending Account
HRSDC	Human Resources and Social Development Canada
IBNR	Incurred But Not Reported
IPP	Individual Pension Plan
ITA	*Income Tax Act* (Federal)
IVR	Interactive Voice Response
LDI	Liability Driven Investing
LIF	Life Income Fund
LIRA	Locked-In Retirement Account
LLP	Lifelong Learning Plan
LRIF	Locked-In Retirement Income Fund
LTC	Long-Term Care
LTD	Long-Term Disability
MCCSR	Minimum Continuing Capital and Surplus Requirements
MEPP	Multi-Employer Pension Plan
MESSQ	Ministry of Employment and Social Solidarity of Quebec
MIE	Maximum Insurable Earning
MS	Morneau Sobeco
MUPP	Multi Unit Pension Plan

NCDB	Negotiated Cost Defined Benefits
OAS	Old Age Security
OMERS	Ontario Municipal Employees Retirement System
OSFI	Office of the Superintendent of Financial Services
PA	Pension Adjustment
PAR	Pension Adjustment Reversal
PBGF	Pension Benefits Guarantee Fund (Ontario)
PBM	Pharmacy Benefit Manager
PBSA	*Pension Benefits Standards Act* (Federal)
PHSP	Private Health Services Plan
PIPEDA	*Personal Information Protection and Electronic Documents Act* (Federal)
PPN	Preferred Provider Network
PSPA	Past Service Pension Adjustment
QPIP	Quebec Parental Insurance Plan
QPP	Quebec Pension Plan
RAMQ	Régie d'assurance-maladie du Quebec
RCA	Retirement Compensation Arrangement
RPP	Registered Pension Plan
RRIF	Registered Retirement Income Fund
RRSP	Registered Retirement Savings Plan
RSF	Rate Stabilization Fund
SDA	Salary Deferral Arrangement
Section 3461	CICA Handbook, Section 3461, "Employee Future Benefits"
SEPP	Single Employer Pension Plan
SERP	Supplemental Executive Retirement Plan or Supplementary Employee Retirement Plan, depending on the circumstances.
SIN	Social Insurance Number
SIPP/G	Statement of Investment Policies and Procedures or Goals
SMEP	Specified Multi-Employer Pension Plan
SOMEPP	Specified Ontario Multi-Employer Pension Plan
SPPA	*Supplemental Pension Plans Act* (Quebec)
SRI	Socially Responsible Investing
SRP	Supplementary Retirement Plan
STD	Short-Term Disability
SUB	Supplemental Unemployment Benefits
TFSA	Tax-Free Savings Account
TPA	Third Party Administrator
UI	Unemployment Insurance

WC	Workers' Compensation
WCB	Workers' Compensation Board
YBE	Year's Basic Exemption
YMPE	Year's Maximum Pensionable Earnings, as defined under the Canada Pension Plan. Similarly, "MPE" refers to Maximum Pensionable Earnings under the Quebec Pension Plan.

TABLE OF CONTENTS

PART I

RETIREMENT INCOME ARRANGEMENTS

OVERVIEW OF RETIREMENT INCOME ARRANGEMENTS

Executive Summary

More than ever before, governments, employers and employees are concerned about pension planning.

This chapter describes the changing environment within which pension arrangements operate, and looks at how governments, employers and employees view pension arrangements. The different types of government and employer pension arrangements are described, as are the issues that an employer might consider in choosing a pension arrangement that best meets its needs and the needs of its workforce.

The balance of the chapters in Part I describe the pension programs sponsored by government and the variety of plans sponsored by employers in more detail. The typical terms and conditions found in employer plans are described, as are the considerations, including legislation, that an employer will take into account when deciding on these terms and conditions. While the focus is on registered pension plans, Part I also reviews other supplementary plans for executives and other retirement income and savings arrangements.

Part I also looks at governance issues generally — the administration and financial management of pension plans and the investment of pension fund assets. A specific chapter in Part III, Chapter 27, *Govern-*

ance of Retirement, Savings and Other Benefit Plans, is devoted to the recent development of governance guidelines in Canada and compliance with those guidelines. Finally, since pension arrangements operate in a complex legislative environment, separate chapters in Part I are devoted to the taxation system in which retirement arrangements operate and to pension standards legislation.

History

Informal pension arrangements existed in Canada as early as the late 1800s to provide benefits to employees who were no longer able to work or to widows of former employees. In 1887, the federal government passed the *Pension Fund Societies Act*, which enabled employees to establish pension funds to which an employer might or might not contribute. A few of these societies still exist. The federal government further encouraged the implementation of pension plans through income tax legislation introduced in 1919. This legislation allowed an employee to deduct from taxable income the contributions made to a pension plan. Further changes to income tax legislation, in later years, allowed employers to deduct their contributions to pension plans on behalf of their employees.

Pension arrangements were originally provided on a pay-as-you-go basis. In 1908, the federal government passed the *Government Annuities Act*, which provided a means of pre-funding pension benefits. Government annuities were discontinued in 1975. Canadian insurance companies introduced group annuity contracts for pension plans during the 1930s as an alternative to government annuities. In 1961, insurance companies were authorized to establish segregated pension funds, and since that time, group annuity contracts have largely been replaced by segregated fund and deposit administration contracts. Today, while just under 58%[1] of pension plans are funded through insurance company contracts, these plans tend to be small (in terms of numbers of members) and account for only 17% of the total membership of all Canadian employer-sponsored pension plans. Large employers favour trusteed arrangements under which they assume responsibility for the investment of pension fund assets. Assets are generally held by a trust company or individual trustees and investment of these assets is typically delegated to one or more investment managers.

Canadian governments have also actively implemented broad-based retirement programs. Old Age Security (OAS) pensions were first introduced by the federal government in 1952. The Canada

[1] Source: Statistics Canada, *CANSIM, table (for fee) 280-0014*.

and Quebec Pension Plans were established in 1966 and the Guaranteed Income Supplement (GIS) was introduced in 1967. In recent years, these arrangements have been subjected to intensive scrutiny due to concerns over their long-term financial viability. In 1989, Old Age Security ceased to be a universal arrangement when benefits became subject to a clawback for high income earners. The future of the Canada and Quebec Pension Plans (CPP and QPP) was somewhat uncertain in light of escalating contribution requirements and the changing demographics of the Canadian workforce. This prompted the government to review proposals for reform of the CPP/QPP to ensure it would be sustainable in the long run, without placing too much of a financial burden on future generations. In 1998, a variety of amendments were made to both the CPP and QPP to ensure both plans' financial sustainability, including a new schedule of contribution rates. Further details on government-sponsored arrangements are found in Chapter 3.

The first of the provincial pension benefits acts was introduced in Ontario in 1965, and it provided improved vesting and funding of benefits under employer-sponsored pension plans. Today, nine provinces plus the federal government have comparable legislation (referred to throughout this *Handbook* as pension standards legislation) in place.

Major reform of the legislation took place in the 1980s and early 1990s. Revisions were made to the minimum standards for employer-sponsored arrangements, covering such items as eligibility for plan membership, vesting of pensions for terminated employees, and benefits for spouses of plan members, as well as administration and governance. Furthermore most provinces continue to adjust their pension legislation on a fairly regular basis and some provinces have since adopted a third set of reform-type legislation (Alberta, effective March 1, 2000 and Quebec, effective January 1, 2001). Further initiatives for reform have emanated from the Canadian Association of Pension Supervisory Authorities (CAPSA) in the form of pension governance guidelines and the proposed principles for a model pension law.

In the early 1990s, the federal government introduced major changes to the *Income Tax Act* (ITA), which significantly changed the tax treatment of retirement savings arrangements. The government's stated purpose of this "tax reform" was to put members of all types of retirement arrangements on a "level playing field" and to eliminate the more favourable treatment previously enjoyed by members of employer-sponsored pension arrangements. In the 1997 Federal Budget, an adjustment known as a Pension Adjustment Reversal (PAR) was introduced to deal with concerns that some of these "equality" provisions introduced in 1992 were actually creating inequitable results for some plan members. Chapter 7 provides additional information on the taxation of retirement savings arrangements.

In the province of Quebec, legislation was adopted in 1997 to provide phased retirement provisions, permitting employees to receive an annual lump-sum payment from their pensions while continuing employment. Alberta subsequently enacted similar legislation. Phased retirement is discussed in more detail in Chapter 2.

The federal government is likewise promoting the concept of "phased retirement".

Shifts in demographic patterns have brought about a reduction in the working-age population coupled with a reduction in the number of years worked by this group. There has been a constant reduction of the number of people in the age 15–65 group and an increase in the post-65 age group. Further, between 1970 and 2005, the median retirement age dropped from 65 to just below age 61. In an effort to address the looming labour shortage as the baby boomers start to retire, proposed changes to the ITA were introduced in the 2007 Federal Budget to allow defined benefit members who have met certain age and benefit entitlement tests (but at age 60 in any event) to receive a partial payment of their accrued pensions while concurrently accruing pension credits should their employment continue during this "phased retirement" period.

The effectiveness of the proposed tax changes to promote the "phased retirement" concept is questionable. It focuses on the provision of Regulation 8503 of the ITA, which prohibits members from earning credited service under a defined benefit pension plan in respect of periods during which they are receiving a defined benefit pension from the same employer. Many questions remain unanswered. Employers are not obligated to offer this program. Furthermore, employers are likely to favour offering this program to selected individuals rather than to a whole class of employees, but this may not be allowed by law. Also, a majority of the provinces have yet to make changes to their respective pension laws to accommodate the phased retirement concept.

Present Position

Canadians typically receive retirement income from three key sources: government-administered pension programs, employer-sponsored retirement savings programs and personal savings. Each of these sources is sometimes referred to as one leg of a three-legged stool.

Government Pension Programs

Government-administered pension programs include two distinctly different programs:

- OAS and GIS, which supply the base of the retirement income system and are financed out of general tax revenues; and
- CPP/QPP, which are work-related arrangements with earnings-based benefits financed solely by employee and employer contributions.

Currently, all persons who have resided in Canada for a sufficient period are entitled to the Old Age Security benefit commencing at age 65. For those with sufficiently high individual incomes, however, Old Age Security benefits will be entirely taxed back. For those with small incomes, a Guaranteed Income Supplement and an Allowance (paid to spouses and common-law partners of pensioners) may also be payable. Old Age Security benefits are now taxable; in contrast, the benefits from the Guaranteed Income Supplement and the Allowance are tax-free.

In addition to these federally administered social security programs, some provincial programs, such as Ontario's Guaranteed Annual Income System (GAINS) program, also provide pension supplements, subject to an income test.

The CPP and QPP provide a basic level of earnings replacement on earnings up to the Year's Maximum Pensionable Earnings, which is linked to the average Canadian wage and is indexed annually. Virtually all employees and self-employed persons in Canada, other than those with very small earnings, must contribute to one of these plans. Unlike the social security programs, which are income-tested, the CPP and QPP are universal and are financed solely by contributions from employees, employers and the self-employed, without any government subsidy. The benefits are payable in addition to Old Age Security and benefits from other income-tested programs. Benefits from the CPP and QPP are subject to income tax. Chapter 3 provides more details on government pension programs.

Employer-Sponsored Pension Plans

On January 1, 2006, there were 15,130 employer-sponsored pension plans in operation, covering nearly 5.7 million employee mem-