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DB plans struggle to survive

Could restoration of tax advantage increase future pension plan coverage?

BY BILL GOODEN

Defined benefit (DB) pension plan coverage in Canada has declined over the last couple of decades, at least within the private sector. While many factors are cited for this decline, one important reason was the attempt to level the playing field in 1991.

Prior to that, meaningful tax assistance was available only to DB pension plans. Defined contribution (DC) pension plans permitted tax-deductible contributions up to only $7,000 per year (and for registered retirement savings plans even lower) while a DB plan could require tax-deductible contributions upwards of $25,000 for older, higher-paid individuals.

Thus, companies looking to reward upper management on a tax-deferred basis were quick to establish DB pension plans. It was almost considered foolhardy for a company not to have one.

Although the motivation to set up a plan may have started with upper management, the rules required other employees in the company to be included in the plan too. However, other employees often meant lower-paid, shorter-service workers for whom DB costs were relatively minor as many of them would leave well before retirement and sometimes receive no pension benefit at all.

Of course, there were other drivers beyond tax reasons to establish plans, such as attracting and retaining employees. And for those who stayed until retirement, upper management and regular employees alike (albeit, often only a small proportion), the DB pension certainly provided a meaningful benefit. Improved vesting regulations established in the mid-1980s also ensured a benefit was there for those terminating mid-career.

Thus, in many cases, even if DB plans proliferated for not the loftiest of reasons, the result was increased pension coverage, which was good public policy.

So, is restoring the tax advantage for these plans the way to increase future pension plan coverage?

The tax assistance part of the scenario changed significantly in 1991 when RRSP and DC (but not DB) contribution limits were increased substantially. RRSP and DC limits were to increase to $15,500 over the following few years while DB limits were to stay the same.

The stated goal was to level the playing field for tax-assisted retirement savings between individuals saving in RRSPs and plan members in workforce pension plans. Consequently, the considerable tax advantage for DB plans over RRSPs and DC plans was substantially reduced. And with that reduction, a powerful incentive to establish private sector DB pension plans vanished.

The proportion of pension plan members who were in DB plans (versus DC) in the private sector dropped from about 90 per cent in 1993 to 56 per cent in 2009, according to Statistics Canada. No such drop occurred in the public sector, where the DB proportion was at 94 per cent in 2009. That year, only 25 per cent of private sector employees were in any type of employer-sponsored pension plan versus 86 per cent of public sector employees.

To be fair, other factors contributed to the DB demise:

- increasingly complex administration due to pension standards legislation that varies by province or jurisdiction
- increasingly complex tax rules, resulting in pension adjustments (PAs), pension adjustment reversals (PARs) and past-service pension adjustments (PSPAs)
- increasingly complex pension accounting rules
- increasing workforce mobility
- surplus ownership disputes.

And, more recently, volatile fund rates of return and low interest rates have added significantly to the risk and cost assumed by the DB plan sponsor.

So, who's keeping DB plans? Public sector employers, politicians, unionized workforces and even some private employers. But why?

Well, for the first two groups, the tax advantage story was never really the motivator the way it was in the private sector — public sector DB pensions were set up early in relatively stable work environments and well-received by employees. Unions recognized DB pensions were good for their members and fought hard to retain them.

Certainly, the demise of DB pensions has come from private sector employers. Not only did existing group DB plans start to fade but few new ones were created. The DB, with its cost, risk and complexities, just does not pass the cost-benefit analysis. Many employers choose, instead, to set up a group RRSP or a DC plan, if anything.

For those that already had a DB plan, however, various tracks were followed: Some changed to DC for new hires, some did not change at all and some completely terminated or converted to DC. While the acquisition of a company might result in the termination of its DB pension plan, for a continuing company it's very disruptive to tinker with the pension plan without some sort of grandfathering.

Will DB plans ever make a comeback?

To improve coverage, the issue of making pensions mandatory has been raised in recent pension reform discussions. However, surprisingly absent from such discussions is the concept of restoring the relative tax advantage to group pensions in order to voluntarily increase coverage. It might be argued the creation of a group plan contributes more to good public policy (because it creates more than one pension) than the creation of an individual RRSP;

therefore, the group plan deserves a relative tax advantage.

Perhaps a DC group plan including the federally proposed pooled registered pension plan (PRPP) should have a tax advantage over a mere RRSP. That is, don't reduce someone's RRSP room as a consequence of being in a DC group plan.

In turn, it's possible a group DB plan contributes more to public policy than a group DC plan and, therefore, deserves an even greater tax advantage for employers willing to make the extra effort to establish them.

Of course, in this day of massive government debt, governments are in no position to make new tax expenditures. But it might not have to cost a lot. In theory, the DB tax advantage could be restored without a net tax expenditure — simply cut back the RRSP and DC contribution limits but not the DB limits. Or, allow future planned DB limit escalations to proceed while slowing RRSP and DC limit increases.

Other issues would need addressing if the formation of DB plans is to be encouraged. Pension standards should be brought under one set of rules such as the federal tax rules. That is, "There is a tax deduction for a pension plan and here's what a minimum standard pension plan is in order to qualify for that tax deduction." It's done that way now, but then it's done all over again with the provinces.

Also, clean up surplus ownership ambiguities through legislation, at least for new plans. To help manage the DB plan employer's cost and risk, key factors will be the selection of an appropriate benefit level and investment policy.

Bill Gooden is principal and actuary at Gooden Actuarial Consultants in Calgary. He can be reached at (403) 263-5027 or wgooden@gooden.ca.