Defined Benefit Plans In Canada - Small Can Be Successful

by David C. Hart

The period from 1970-1990 could probably be called the golden era for defined benefit pension plans in Canada. At the beginning of that period, most actuaries still worked in insurance companies but by the end of that period almost half of Canadian actuaries worked in benefit consulting firms or for the various government pension regulators.

The Federal and Provincial governments kept churning out pension and tax legislation which, as a group, could easily be subtitled *The Actuaries Full Employment Acts*. Although the Federal income tax act regulated pensions and restricted the amount of contributions to a pension fund, pension legislation which protected the pension rights of the plan members fell under individual Provincial legislation or Federal legislation for specific national industries such as banking, transportation and communications.

Alas, death, taxes and change are the only true social constants and change has led to the restriction (but not complete demise) of the defined benefit plans. A risk-averse company philosophy has led many companies to rethink their retirement strategies and to change their retirement plans from defined benefit to defined contribution. Such a change is usually welcomed by younger employees who do not expect to remain with the same employer during their whole working lifetime.

However, the defined benefit plan is still preferred by older workers, employees who expect to remain with an employer until retirement, and high-income-earning decision-makers. For this reason, defined benefit plans are still preferred by government workers, union groups and senior management groups in many, if not most, companies.

As in any other country, federal tax policy dictates the form of individual retirement savings and employer retirement plans. Canadian tax policy has always provided a certain amount of tax relief for retirement savings. Currently, an individual can contribute up to the lesser of 18% of income and $15,500 into a Registered Retirement Savings Plan (RRSP). A company can provide a benefit for an employee of (1) up to the lesser of 18% of income and $16,500 as a contribution into a defined contribution Registered Pension Plan (RPP) or (2) provide a defined benefit, for each year of service, up to the lesser of 2% of projected final average earnings at retirement and $1,833.33. Since 1991, federal tax policy has been coordinated between individual and company registered plans so that the amount of benefit provided by the company plan will lower an individual's maximum contribution to an RRSP.

The Canadian tax policy provides relatively the same treatment for RRSP and RPP plans. The contributions provide a deduction from current taxable income, the investment earnings are not taxed while they remain in the fund, and payments from the fund are taxable income for the individual in the year received as retirement payments out of the

fund. In addition to the contribution for current or past service, a company can pay the expenses of the plan and deduct them as a normal business expense. Only an incorporated company can provide a company pension plan. A sole proprietor or a partner must rely on the individual RRSP for retirement savings.

The maximum pension benefit allowed for each year of service has remained relatively unchanged for almost 20 years. This means that an individual has only been able to receive tax relief on approximately the first $90,000 of earnings. However, this has now changed with positive results for the future of defined benefit pension plans, especially for executives.

A niche market is currently developing for registered executive pension plans (EPP) and individual pension plans (IPP). An IPP is essentially an EPP but with only one member; however, the member is usually given the full right to any surplus and may also be allowed to direct the investment strategy. In some cases an IPP may have two members which are spouses and both shareholders and employees of their company.

There are three major reasons for the current increase in new IPP's. First of all, the tax policy was changed in 2003 to increase the maximum annual pension accrual from $1,722.22 in 2003 to $1,833.33 in 2004, $2,000.00 in 2005 and increasing each year thereafter by increases in the average industrial wage. Maximum contributions to a defined contribution pension plan increase from $15,500 in 2003 to $16,500 in 2004, $18,000 in 2005 and increasing each year thereafter by increases in the average industrial wage. Maximum contributions to an individual RRSP will lag the Defined Contribution pension plan contributions by one year.

Secondly, Ontario, which comprises approximately one-third of the Canadian population, will now allow doctors and dentists to incorporate. These professionals will now be employees, for the first time, of a company that can sponsor a RPP. Third, there is an emerging market of small corporations which after 10 or 20 years are providing a significant revenue to the original owners who are starting to consider saving for retirement. Some of these small businesses are ''mom & pop'' operations with the two spouses jointly controlling the operation.

The target market for IPP's is highly-compensated employees who have previously relied on their RRSP for retirement savings. An individual with earnings in excess of $90,000 can currently contribute up to $15,500 for the year into a RRSP. However, a company can currently contribute to an IPP the amount of $15,700, $18,900, $22,800, and $26,600 respectively for an employee age 35, 45, 55, and 65. These contributions are calculated using a restrictive set of assumptions found in the Income Tax Act and Regulations to determine the maximum contribution allowed for such an executive pension plan. The company can also pay and deduct any plan administration expenses.

The IPP can also provide a past service benefit (while an employee of the company) back to 1991, in which case an amount, which is essentially the contributions originally paid to the individual's RRSP, must be transferred from the RRSP to the IPP. However, the company

must make up any shortfall in the initial liability that would be approximately $8,000 per year of past service for a member aged 60.

In Canada, the funds of a pension plan must be entrusted to either an insurance company or a trustee governed by a trust agreement. A trustee can be either a corporate trustee or a group of three or more individuals, at least three of whom reside in Canada and at least one of whom is independent of any employer contributing to the pension fund.

Having read this far, you are probably now starting to see my line of thought and you now realize that there may be a very worthwhile fit between a small actuarial pension consulting firm and the IPP market. The typical IPP client is usually too small for a larger actuarial consulting firm.

Any pension plan requires the services of an investment manager, a trustee or insurance company which is entrusted with the pension fund and a pension consultant who usually administers the plan. The pension consultant is normally an insurance company or a small pension consulting firm, either of which may use their own actuary or use the services of an external actuary. In some cases, an individual employee of a small pension consulting firm may agree to act as a third trustee in an effort to reduce the high cost of dealing with a corporate trustee. However, that individual trustee is exposed to the risk of a lawsuit that could result in a loss of personal assets.

The IPP market can certainly provide a reasonably lucrative line of business for a small actuarial consulting firm. However, the fees are constrained due to the size of average pension fund. In addition the work requires IPP tax rules expertise, attention to detail, and a considerable amount of administration work to set up the plan and provide the annual maintenance.

The target market for IPP business is normally a financial planner and sometimes an accountant. The pension consulting firm will usually deal with the IPP member through the financial planner and must be prepared to accept that role of secondary advisor.

To succeed in the IPP market, a small actuarial pension consulting firm must develop the systems to handle a large number of cases, standardized documents and administration procedures, be able to cope with the annual surge of time-constrained work during certain periods of the year, and market to as broad a base of financial planners as possible. On paper, it sounds pretty reasonable. In practice, it takes a lot of work.

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