DEVELOPMENT OF EXECUTIVE PENSION PLANS IN CANADA

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EXTRACT

Employer sponsored pension plans which allow employers to make advance financial provision for pensions to employees are major pieces of enlightened employee benefits packages. These plans usually give greater rewards to long term employees. The tax treatment of these employer sponsored plans encourages their development, because employer contributions are not taxed when made but when actually received by the employee. This of course makes sense because it encourages such plans to the advantage of employees, employers and the government.

The rules governing pension plans have allowed highly paid individuals to defer tax on large sums. While the rules have been adjusted over the years the fine art of devising executive pension plans has flourished for some time. It now looks as if the government is determined to make significant rule changes that may, perhaps, bring about the ultimate demise of such plans.

INTRODUCTION

In Canada tax on the earned incomes (salary) of all citizens and corporations is the major source of revenue for the federal government. The Income Tax Act of Canada makes only limited reference to pension plans. The Act says that an employer may contribute up to a specified annual amount to a registered pension plan on behalf of an employee and deduct the contribution from taxable income as a business expense. Individuals are granted the same privilege with the same dollar limit. Another section of the Act allows the employer to

contribute to a registered plan such amounts as are recommended by an actuary and approved by the Minister as being required to provide the benefits promised by the plan. Tax shelter for money purchase pension plans depends on the first section while defined benefit plans depend on both sections.

Generally speaking current service costs are deductible under the first section. In 1989 the specified amounts are $3,500. Thus most plans find that current service costs will, on average, be less than $3,500 per employee. If the plan grants past service benefits, or upgrades of the accrued benefits, or suffers an actuarial loss, the resulting unfunded liability can be funded under the latter section of the Act.

The Income Tax Act provides for the registration of pension plans. To get a plan registered, and qualify for the special tax treatment, the plan must be submitted to the government for approval. The officials have developed a 40 page set of rules that they will follow in deciding whether a plan will be accepted for registration. When the provinces started to regulate pensions, the federal authorities added a requirement that, for federal acceptance, the plan had to be registered provincially, when applicable (only eight provinces have legislation in place).

ILLUSTRATION I

Tax deferred savings vs. after tax savings

Retirement at 65

10% interest

Tax rate 43% before retirement, 25% after retirement

GAM 83 mortality (after retirement)

Pre tax saving $1,000 per annum contributed at the end of the year

Age	Fund at 65		After Tax Pension (annual)	
	Tax Deferred	Other	Tax Deferred	Other
30	$271,024	$55,138	$26,722	$6,292
40	98,347	28,134	9,697	3,210
50	31,772	12,325	3,133	1,406
60	6,105	3,070	602	350

TAX SHELTER THROUGH EXECUTIVE PENSION PLANS

In the early 1960's several life insurance companies (and their agents) discovered that they could register a pension plan covering only one or two people. Usually the plan would call for a maximum pension for service prior to the effective date and the maximum contribution for future service. The annual future service contribution was limited to $1,500 at that time. However because there was no limit to the "obligation" for past service pensions, the past service contributions could be quite large. Many owners of small businesses set up these plans. Contributions of $150,000 to $200,000 for an individual were not unusual. The past service cost could be paid in a lump sum; or spread over future years, thus increasing the annual contributions.

These executive pension plans were usually funded by deferred annuity contracts issued by life insurance companies. Some of the amounts that were put in

the plans were quite impressive. Using actuarial salaries as an index, a recently qualified actuary in the 1960's might expect to earn $10,000 to $12,000. A recently qualified actuary in 1989 might expect to earn $70,000. One of the executive plans in the 60's was seen to require annual contributions of $28,000. At that time, this was a tremendous amount of current income on which to defer taxes.

These plans seemed to be a bonanza for everyone involved. The life insurance agent made a handsome commission, the individual sheltered large sums of money from income tax, the insurance companies welcomed the business and, in the beginning, the federal government thought that their rules to encourage retirement savings were working.

However, the government soon came to realize that these plans were not being used as the government intended and were costly to the national revenue. The plans were seen as unreasonably large tax shelters for newly wealthy entrepreneurs even though they strictly complied with the government's rules.

Because the registration rules were not specified in the Income Tax Act but in Information Circulars, they were easily changed. Soon amendments were made requiring that benefits accrue evenly over the employee's lifetime and that benefits for service prior to the effective date of the plan be in proportion to benefits for service after the effective date of the plan. This ruled out a plan granting the maximum pension for past service and a nominal pension for service thereafter. Such a plan would produce a very large initial unfunded liability which could be funded by a single payment, while future obligations would be minimal. By requiring that the past service benefit be in proportion to the total benefit as years of past service are to total years of service, the government made an important step towards preventing the perceived abuse.

SHAREHOLDER PENSION PLANS

1970 saw a slowing in the development of executive pension plans. After the apparent excesses of the 60's, executive plans (now called top hat plans) became harder to establish. The federal government added a rule which said that a pension plan could not be primarily be for the benefit of significant shareholders, defined as employees holding 10% or more of the company stock.

Furthermore, interest rates were starting their inexorable creep upward. People paying 9% or 10% interest on a mortgage were not interested in receiving 4% or 5% on a deferred annuity contract. Because interest rates seemed to be on an upward spiral people were more interested in investing where they would get the benefit of the increasing interest rates rather than being locked into a lower guaranteed rate such as was seen in guaranteed annuity contracts. This discouragement was softened as new investment vehicles were developed for tax sheltered money by trust companies and life insurance companies. Such executive plans as were registered tended to use investment funds set up by trust companies and life insurance companies, rather than deferred annuity contracts.

In 1980 the federal government made a dramatic change by removing the prohibition on significant shareholders. This meant that a significant shareholder who was an employee of a company could have a pension plan subject to the same rules and limits as any other employee. Everybody jumped on the bandwagon. Insurance companies were ready with investment funds that did not lock in funds for prohibitively long periods and that credited higher interest rates. Mutual funds were available as well as investment vehicles that guaranteed the return for as long as 15 years. Even on the 15 year guaranteed contracts, there was a rollover of funds so that the individual could see his investment return and part of his principal being reinvested at the ever increasing rates that the market place was producing. There were many small time entrepreneurs who had fairly significant sums of money that they wanted to tax shelter. It almost seemed that a great pent up demand was suddenly given an outlet.

"Shareholder pension plans" became a very hot topic. Generally these were defined benefit plans with benefits related to salary and service, financed by the employer. The income tax rules said that the contribution required to produce the benefit, if recommended by an actuary and approved by the Minister, would be deductible from taxable income by the employer corporation. Thus given the benefit level, it was the actuary's job to determine the contributions required to fund the benefit.

MAXIMIZING THE TAX

In Canada the unit credit method is the most common actuarial cost method. Under this cost method, one determines the single sum required at the effective date to fund all benefits earned for service prior to the effective date. One also calculates the annual cost of benefits accruing after the effective date. This method results in costs which increase each year as the individual grows older. For one-person plans it is common to use a level premium funding method, rather than unit credit, for future service costs. Hence one would calculate the lump sum required to fund all benefits expected to be earned in the future and then spread this amount evenly over the period between the effective date of the plan and the individual's normal retirement date.

Rules in the Information Circular (not in the Income Tax Act) limit the amount of pension that can be provided under a registered plan. The maximum pension allowed is 2% of salary to a maximum salary of $85,750 for each year of service to a maximum of 35 years. This pension can start any time after age 60. Salary for this purpose may be the final average salary in the three years preceding retirement. Pensions starting at retirement may be indexed to inflation.

Two main factors enter into the calculation of the cost of the pension, the mortality and interest assumptions. The differences between the mortality tables that are commonly used are small. The interest rate assumption on the other hand can have a very great effect on costs.

Within these rules, it is quite possible to design a pension plan which will produce a specified level of contributions, especially if the shareholder has several years of past service. While some shareholders requested plans that call for the maximum contributions, it was more usual for a shareholder to request that the plan require contributions of say $20,000 a year. The actuary would then try different combinations of factors (plan design and assumptions) to produce the required contribution level. This type of activity is acceptable if the assumptions are within reasonable limits. Unfortunately for the shareholder pension business, it seems that in the 1970s some people took the method too far.

Generally accepted interest levels for pension plan funding were in the 6% to 8% range. Rather than sticking with the traditional and current levels some actuaries submitted for registration pension plans which were valued using interest rates of 4% - or even less. When the client requested a plan calling for the maximum contribution, the more aggressive actuaries would use very low interest assumptions and by this means increase greatly the contributions required. The government was quick to move against this method and two days before the end of 1980 a special set of rules for shareholder pension plans was issued.

RESTRICTIONS ON SHAREHOLDER PLANS

The new rules required that shareholder plans fund for retirement at an age not earlier than 65, required an interest assumption of not less than 8% for 15 years and 6% thereafter and limited indexing to a rate not greater than 4% less than the interest rate. This latter rule means that post-retirement increases were limited to 4% during the first 15 years and 2% thereafter. Thus for an individual who was 55 when the plan was started, the actuary would use 8% interest to age 65, 8% interest and 4% indexing to age 70 (the first 5 years of pension payment) and 6% interest with 2% indexing thereafter. The new rules also said that any initial unfunded liability had to be funded over a period not less than 9 years. All these rules were obviously designed to restrict the amount of money

that could go into a shareholder plan and give some assurance that the deduction would be spread over a period of time.

A further rule required the benefit to be paid as a life annuity purchased from a life insurance company. The final rule was that the government would not accept any new shareholder pension plans filed after December 31, 1980.

Although shareholder plans were banned, interest in plans for other executives revived. The distinction between shareholder plans and executive plans is that while both are written on the life of one person (or very few), the shareholder plans relate to employees who own 10% or more of the company and the executive plans relate to employees who usually are not significant shareholders. There is one circumstance under which a significant shareholder can be considered an executive. This occurs when the total liability under all company sponsored pension plans for employees who are not significant shareholders exceeds the total liability for significant shareholders.

ILLUSTRATION II

Contribution levels under various age and service circumstances and various assumptions.

Starting salary $50,000
Annual increase 4%
Male life Individual Annuitants Table (1971) mortality after retirement
Post retirement guarantee 10 years

a) Age 45, 10 years of service.

	Expected Pension	Initial Liability	Amortization Payment	Normal Cost
1)	39,778	31,600	3,254	3,160*
2)	51,450	50,271	8,047	10,169
3)	51,450	57,180	5,887	9,970
4)	51,450	78,525	8,085	13,692
5)	42,875	82,830	8,528	12,793
6)	42,875	19,542	12,308	18,463
7)	42,875	161,384	14,515	21,773

*Increases each year by 10.24%, all others are level annual

b) Age 55, 25 years of service.

	Expected Pension	Initial Liability	Amortization Payment	Normal Cost
1)	37,006	141,470	19,221	5,660*
2)	49,841	205,031	32,821	12,222
3)	49,841	212,569	28,881	11,553
4)	49,841	291,920	39,663	15,865
5)	35,114	253,091	60,083	12,017
6)	35,114	365,267	86,713	17,343
7)	35,114	407,591	91,556	18,311

* Increases each year by 10.24%

Note: 1) Career average, retire at 65, not indexed, 6% interest
2) Fixed 3 year average, retire at 65, indexed, 8%/15 years, 6% after
3) Fixed 3 year average, retire at 65, not indexed, 6% interest
4) Fixed 3 year average, retire at 65, indexed, 6% interest
5) Fixed 3 year average, retire at 60, not indexed, 6% interest
6) Fixed 3 year average, retire at 60, indexed, 6% interest
7) Fixed 3 year average, retire at 60, indexed, 4% interest

The federal rules restricting existing shareholder pension plans caused some actuaries problems. The 8% interest assumption was, in the early 80's, considered to be more aggressive (i.e. higher, producing lower costs) than the rate most of us would choose to adopt. The mandated difference between interest and inflation (4%) was also considered somewhat high. Most of us would feel more comfortable with an assumed difference of 3% or even 2%.

Perhaps the most important problem was the fact that the rules allowed for an unreduced pension starting any time after age 60, although the employer was required to fund for a pension starting at age 65. The most extreme example of the problem this would cause would be the case of a shareholder who would have the maximum 35 years of service at age 60 and would, at that time, be eligible for a full pension. The plan that funded for the full pension to start at age 65 would certainly turn up with an unfunded liability were the shareholder to choose to retire at age 60.

ILLUSTRATION III

Reserve at 60 vs. actuarial value of accrued pension.

At Effective Date		At Age 60	
Age/Service		Reserve	Value of Pension
45	10	435,570	573,580
55	15	187,230	309,630
55	25	264,250	464,440
60	20	197,849	274,175
60	30	296,758	411,264

PROVINCIAL LAWS

There are other players in the regulatory game, namely the provinces. Their function can best be summarized as protecting the interests of pension plan members. In particular the provincial laws are aimed at ensuring that plan members receive the pensions promised by establishing strict standards of solvency. Hence it is quite possible that there will be a conflict between federal rules and provincial rules. One might have expected that the provinces would not be willing to accept pension plans under which the funding was likely to be deficient as was the case in executive plans where we funded for retirement at 65 knowing that the employee was entitled to an unreduced benefit at age 60. The 8% interest assumption was also greater than the rate in the provincial guidelines. Perhaps wisely the provinces chose to ignore these problems. It would seem that the only people that were greatly concerned with them were those who wanted to increase the amount of tax deferred contributions to shareholder plans.

SALARY SACRIFICE

Individual executives came to realize that pension plans provided them with unusual opportunities for tax deferred savings. The Income Tax Act allows an in-

dividual to contribute an amount to an individual registered retirement savings plan. This amount was stuck at $5,500 for many years and only in the last five years was it moved up to $7,500. High paid executives often preferred to obtain tax shelter on much larger amounts, which may be possible through an individual pension plan.

Hence an individual executive would make a deal with his employer. The individual's salary would be reduced by a certain amount and a pension plan would be established that required company contributions equal to the reduction in salary - a method known as plan funding through salary sacrifice. The amount necessary to fund the plan as recommended by the actuary and approved by the Minister will be accepted as an expense of the company for tax purposes, and is not taxable to the individual. Thus with the heightened interest in using pensions as tax deferral vehicles, there was an obvious place for the enterprising pension consultant. The task was to find executives who wanted to tax shelter large amounts of money, convince them that a pension was the right way to go and then find the combination of plan provisions and actuarial assumptions that would require the contribution which the executive had stipulated. Business boomed. The government was satisfied because all the rules were being followed, the actuaries were happy because there was lots of work to do and the individual taxpayers were delighted to be able to tax shelter so much money.

A further feature making these plans attractive was that investment organizations were offering a wide choice of pooled investment funds. These pooled funds were generally unitized diversified investment funds (referred to earlier as mutual funds). The manager would have discretion over the asset mix and would invest the money in a combination of bonds, stocks and cash. In the first six years of the 1980's these funds did very very well. Individual pension funds were no longer seen as requiring low yield investments, as was the case with deferred annuities.

PENSION FUND SURPLUS

In one respect, the greater investment returns could present some difficulties in the future. This is because the federal government has another rule which says that special payments (for past service obligations or deficiencies) are not permitted if there is a surplus in the pension fund. With interest assumptions that were appropriate for funding purposes, but much lower than actual returns, it is easy to see that surplus will arise in these pension funds. This could lead to a situation in which the contribution level has to be restricted. In this case, the executive may be concerned that the amount of salary that he is sacrificing isn't really going into the pension fund.

Surplus considerations arise in another place. The federal rules concerning shareholder plans specifically stated that a pension was to be purchased as an annuity at the retirement of the individual (this rule was relaxed in 1985). In fact it makes sense in most one-person pension plans for an annuity to be purchased at retirement. However, as the amount of money in the fund at retirement would be based on an assumed interest rate which was considerably lower than the market rate for immediate annuities, the purchase of the immediate annuity would release assets and hence produce a surplus. The federal rules require that any such surplus reverts to the employer, a situation that would not sit well with an individual who had sacrificed salary to build up the pension fund.

There was a way around this rule though. Just before the individual was to retire, the pension plan would be terminated. As a termination benefit, the individual would receive the actuarial reserve of the pension accrued to date. This termination benefit could be rolled over to an individual registered retirement savings plan and no tax would accrue on the rollover. Under individual RRSPs there is no limit as to how much pension can be produced by the money in the plan and as a consequence the individual could receive not only all of his salary sacrifice but also a pension which was much greater than the federal maximum.

An inevitable extension was that pension plans would be used to shelter from tax large amounts of money in one payment. There would be no intention of carrying the plan on into the future. This option proved attractive to individuals who were entitled to large payments such as bonuses or termination payments; these were forfeited in return for an equivalent payment into a pension fund. In some cases pension plans were set up for one person - even after he had been fired. All or part of his termination settlement was paid into the plan and the plan was collapsed as soon as it was approved for registration. The money would move tax free to an individual registered retirement savings plan. A payment of $200,000 would now be invested in a savings plan - much better than paying $100,000 to the government and only having $100,000 to invest.

THE FUTURE

Throughout the 1980's the federal government, chronically strapped for funds, was working diligently to close the holes in the Income Tax Act that allowed individuals to defer tax on large amounts of income. The popularity of executive pensions was enhanced by being the only game in town.

It seems that a government will tolerate an unconventional use of the Income Tax Act so long as the situation doesn't get out of hand. Wherever this fine line is, it was crossed in 1988. The amount that can be transferred to another savings plan is now limited to the market value of the accrued pension. Since early 1989 acceptance for registration has been put on hold. Plans are not being rejected - yet. Rather nothing is being done while efforts are being made to formulate new rules.

It seems likely that the new rules will specifically reject plans funded by salary sacrifice - perhaps with emphasis on plans covering only one person. For all the large amounts that are being sheltered there are many employees whose pensions, in relation to their pay, are as generous as the executive's pensions. Some-

times the difference is that the executive plan is funded all at once. Often it is only that the amounts contributed for a specific person are more visible. Also the funding of the executive plan is more obviously coming from money the executive employee could have taken as (taxable) income.

There is great support for tax deferred pension plans. With government cutting back on expenditures, any program which encourages self sufficiency must be encouraged. Thus there must be a solution which leaves private pensions as an attractive option but curbs so-called abuses. Rules meant to prevent specific actions are never completely effective. If the government again tries to restrict executive plans we can be reasonably confident that someone will find a way to use the new rules to their individual advantage.

Modern computer power has opened the door to treating all the individuals within a group on an individual basis. As flexible employee benefits become more popular we can only hope that no new rules will be brought in to stop the development of individual pension plans.