THE TAXATION OF RETIREMENT SAVINGS IN CANADA

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1 INTRODUCTION

Retirement income for the elderly is provided through a combination of state pensions, employment pension plans and individual arrangements. With the growth in the number of the elderly in relation to the working population, and the resulting drain on national revenues for pension and health benefits, a number of governments have been considering how the best mix of these three income sources can be achieved.

In Canada the challenge of an ageing population has led to three important developments in the last few years:

* The contribution scale for the Canada/Quebec Pension Plan has been considerably increased, although the benefits are essentially unchanged.

* The regulation of private pension plans, which is mainly a provincial responsibility, has been greatly expanded.

* The taxation of retirement savings has been fundamentally reformed and now incorporates a number of new principles.

This paper describes the new system of taxation for retirement savings, recently enacted by the Government of Canada. It then discusses the extent to which the new system has met the objectives of fairness and tax neutrality, and the implications for the design of retirement plans. First we outline the main provisions

of the old and the new tax laws applicable to retirement savings.

2 THE OLD SYSTEM

In Canada, contributions to registered retirement plans, by both employers and employees, are tax-deductible within limits; the investment income of the pension plan's assets is not taxed; and all amounts paid out are taxable. There are three registered plans that provide tax shelter for retirement savings - the Registered Pension Plan (RPP), the Registered Retirement Savings Plan (RRSP) and the Deferred Profit Savings Plan (DPSP). Tax deductible contributions may be made to RPP by employers and employees; to RRSP by anyone with earned income; and to DPSP by employers only.

Under the old tax system, coordination between these three plans was rough and ready. The maximum contribution to RRSP for a member of an RPP or DPSP was less than for a non-member. In spite of this, members of RPPs, particularly non-contributory plans, could obtain far more tax shelter than other individuals. A further problem with the old system was that the tax shelter could be greatly increased by various devices and through loopholes which allowed "double dipping" (that is, making tax deductible contributions twice for the same period of service).

3 HISTORY

The Bill containing the new system had its third reading in the House of Commons on June 21, 1990, was approved by the Senate on June 27 and received Royal Assent the same day. The new system came into effect starting with the 1991 tax year. Thus ends a project that began at least eight years ago, when the Parliamentary Committee on Pension Reform, chaired by Douglas Frith, presented its report in 1983. That committee unanimously recommended that the same limit on tax-assisted contributions should apply to retirement savings, regardless of the retirement savings vehicle (RPP, RRSP, DPSP or a combination). This is the basic principle of fairness or tax neutrality in the new tax system.

A majority of the committee recommended a low dollar limit on contributions, such that the maximum pensionable earnings for full tax shelter would be 1-1/2 times

the average wage; in fact, the maximum in the new law is about 2-1/2 times.

It took time to develop the necessary reforms. The shape of things to come was first seen clearly in the Ways and Means Motion of October 1986. With one exception the principles in the Ways and Means Motion were adopted by the Standing Committee on Finance in 1990, and the following system became law.

4 THE NEW SYSTEM IN BRIEF

Contribution limit.

The contributions for an individual are limited to 18 % of earned income, subject to a dollar maximum which will be $ 15,500 a year after a transition period. This limit applies to the total of all tax deductible contributions of an individual and the employer on his
behalf(or their deemed value).

Pension Adjustment (PA).

Tax deductible contributions to RRSP are limited to the contribution limit minus a Pension Adjustment, if any. For a member of a defined benefit pension plan the PA is equal to 9 times the annual pension for the year, reduced by $ 1000. For defined contribution plans or DPSPs the PA is simply the total contributions, plus any surplus or forfeitures allocated to the member's account.

Carry forward.

Taxpayers who do not contribute to RRSP their maximum for the year have the right to carry forward to future years the unused RRSP contribution room up to a dollar maximum.

Past Service Pension Adjustment (PSPA).

Improving the past service benefits in a pension plan may in some circumstances give rise to a PSPA which, like a PA, reduces the RRSP contribution room. However, certain changes, for instance amendments to increase pensions in

relation to rising prices or earnings will have no effect on the contributions that may be made.

Maximum pension.

There are two limits on the amount of pension that may be provided from a defined benefit pension plan:

(a) the pension per year of service may not exceed 2 % of the best three years average earnings (indexed for inflation), and

(b) the pension per year of service may not exceed $ 1722.22 a year.

It should be noted that these pension limits are precisely consistent with the contribution limits, since applying the 9 times factor generates the maximum contributions of 18 % of earnings and $ 15,500.

Timing.

Employers operating registered pension and deferred profit sharing plans must report the PAs for each tax year within 60 days of the year end. In order to allow time for reporting and administration, the RRSP limit for a year will be based on the PA for the previous year. Revenue Canada will advise taxpayers each year of their allowable RRSP contributions.

General.

The Act has long and detailed provisions codifying the old rules and practices, governing pensions for certain highly paid employees and respecting anti-avoidance and enforcement.

5 IMPACT OF THE NEW TAX PRINCIPLES

The new system embodies a number of interesting principles that are new to Canada.

Equal tax shelter regardless of the vehicle

The fundamental principle is that the same total tax shelter should be allowed whether the retirement savings are provided through a Registered Pension Plan (RPP), a Registered Retirement Savings Plan (RRSP), a Deferred Profit Sharing Plan (DPSP) or a combination. The system should be tax neutral to these vehicles.

While at first sight the fundamental principle appears obviously fair, it is open to serious criticism. RPPs are subject to strict rules of both the tax and regulatory authorities to ensure that the benefits can only be taken in the form of life annuities. On the other hand, the assets of RRSPs and DPSPs do not necessarily provide retirement income at all but may be withdrawn in cash at the option of the individual. Some people argue that the more strictly regulated plans, which cannot be used to produce anything but retirement income, deserve more encouragement through favourable tax treatment than plans that can be cashed in easily. Few workers will be farsighted enough to make proper provision for their old age without tax incentives.

Other people including many economists argue that savings in general, not just savings through registered pension plans, are equally worthy of government encouragement. People save for many good reasons. They save against the time when they are old or sick or unemployed; they save to buy houses or set up businesses. Governments may wish to promote all these forms of saving. The case for giving special tax treatment to registered retirement plans as opposed to other forms of saving is not very strong but is well entrenched.

Combined employer and employee contributions

The second principle is that the contribution limit should apply to the total of employer and employee contributions. In Canada, employees' contributions to Registered Pension Plans are tax-deductible, up to certain limits. This being so, the new legislation recognizes for the first time that the tax implications of contributions to a pension plan by the employer and employee can be regarded as indistinguishable. From the tax point of view it is the same whether an employer (a) makes a contribution to an RPP on behalf of a particular employee or (b) pays the employee an equal amount so that the employee can contribute it to the plan. Yet in the past, the allowable tax deductions were different, depending on whether the contributions were made by the employer or by the employee and on whether they related to current

or past service. Treating employer and employee contributions in the same way is a logical improvement on the old system.

A contribution equivalent to a defined benefit

The third principle is that for tax purposes a defined amount of pension should have a contribution equivalent. Otherwise the new tax rules could not encompass both defined benefit pension plans and defined contribution (money purchase) arrangements in one comprehensive system.

Unfortunately, the contributions of the employer for an individual in a defined benefit pension plan cannot be known with any precision. They can only be estimated based on actuarial assumptions that will depend on the characteristics of the workforce, the investments of the fund and the opinion of the actuary. Such an estimate is not definite enough to be desirable in a tax system.

Accordingly, pension plan members will have their maximum allowable contributions to RRSP reduced by a Pension Adjustment (PA) specified in the Act. The PA in a defined benefit pension plan is arbitrarily defined as 9 times the annual pension accrued in the year, minus $ 1000. The rationale is that the 9 times factor, representing the deemed value of the pension, would be appropriate for a pension plan of the public service type - a final salary plan, indexed for inflation, with survivor benefits. The $ 1000 was an arbitrary allowance made at least in part because most pension plans do not have as generous ancillary benefits as the plan on which the 9 times factor was based. It also means that all pension plan members can make at least some RRSP contributions.

An actuarial valuation relating a future unit of pension to a present amount of contribution, which might be considered to produce a fair value conversion factor, should vary depending on such items as the employee's age, the retirement age and the terms of the particular pension plan. Much debate took place on whether the 9 times factor should be changed to take account of the age of the employee, the type of pension plan (career average, flat benefit or final average) or the ancillary benefits (indexing for inflation, survivors' benefits, etc.). As these variations would have made the administration of the system by both employers and the government impossibly complicated, they were rejected. Theoretical equity had to be sacrificed to practicality.

As the old system's bias in favour of defined benefit RPPs has been removed, it is not surprising that increased attention is being paid to defined contribution RPPs and to group RRSPs.

Where there is a defined benefit RPP the greatest tax shelter can be obtained by maximizing the ancillary benefits. We may therefore expect to see a move towards more generous early retirement provisions, inflation protection, death and disability benefits, at least for highly paid employees.

Flexibility in timing of contributions

In the past tax shelter was a "take it or leave it" proposition. Unused tax shelter could not be carried forward from year to year, except in the sense that a registered pension plan could be amended to create or increase past service benefits.

Now an individual who does not contribute the full RRSP allowance for a year may carry the balance forward indefinitely, subject to a dollar maximum. This is an undoubted improvement in the fairness and flexibility of the system.

Maximum pensions and contributions

The limits on pensions and contributions noted above will severely restrict the tax deductions that high income earners may obtain on their retirement savings. After 1994, the earnings on which full tax shelter can be obtained will be limited to about 2 1/2 times the average industrial wage - down from about 7 1/2 times in 1976.

Because a growing numbers of employees, not only top executives, will by 1995 be affected by the maximum, increased use of supplementary non-registered pension arrangements and perhaps the evolution of new variations may be expected.

6 PAR - A REJECTED PRINCIPLE

Another principle, which appeared in the original bill but was finally rejected, is the Pension Adjustment Reversal (PAR). The principle is that an individual who terminates employment and thereby loses tax shelter benefits - either because the pension is not vested or because the commuted value transferred out is less than its deemed contribution equivalent - shall be granted a (PAR) so that he or she regains the lost contribution room. This was one of the pillars of the original proposal. It

resulted in a completely logical and equitable system - assuming only that the 9 times factor truly represented the value of a unit pension, which of course was rarely the case.

However, the PAR concept did not survive the hearings on Bill C-52 before the Standing Committee on Finance. Almost every speaker who gave evidence in the hearings criticized the overall complexity of the new arrangements. The committee's solution was drastic - it abolished the PARs and in partial compensation granted an increase in RRSP contribution room to all members of defined benefit plans (i.e. the PA became 9 times the pension minus $ 1000 instead of 9 times the pension minus $ 600 as originally proposed). Thus in a trade-off the complexity of the system was reduced and so was the equity.

The elimination of PARs means that mobile employees (many of whom are women) are the losers. However, it simplifies the system by avoiding a great many calculations that would otherwise be required for workers who change their jobs.

7 CONCLUSION

How should we appraise the end result of the long process of reforming pension taxation in Canada?

First, it is a compromise. Political decisions are nearly always the result of a compromise that does not fully satisfy anyone. The Act as amended and finally adopted does not have the intellectual appeal of the 1986 Bill, since the elimination of PARs has destroyed one of the main principles of the original proposals.

Nevertheless in spite of its imperfections the new system is better balanced and allows more tax saving for most workers than the previous system.

The new tax system substantially alters the balance of advantage between defined benefit pension plans and defined contribution arrangements, including RRSPs. A strong trend to defined contribution plans has already become evident in the last five years, largely because of provincial pension legislation which is far more onerous for defined benefit than defined contribution plans. The possibility that inflation protection will be required by law in Ontario acts in the same direction. Now the tax reform applicable to retirement savings will add force to the trend.

Finally, the low limit on the pensionable earnings on which full tax shelter

may be obtained will cause actuaries to pay increased attention to non-registered retirement plans and other deferred income arrangements for individuals with high incomes.

The Senate recommended that the Act should be reviewed in three years time, after experience has been gained as to its operation and administrative costs. We can be certain that change will continue. The actuarial profession, besides taking into account in its work the new tax principles, should exert its influence as the evolution of the system continues.