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E-BRIEF

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PENSION POLICY

The Taxation of Single-Employer Target Benefit Plans – Where We Are and Where We Ought To Be

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- Many employers have been looking for alternatives beyond traditional pension arrangements to better manage their pension risks. Target Benefit Plans (TBPs) are an attractive hybrid of traditional defined-benefit and defined-contribution plans since they combine fixed contributions with targeted pension payments.
- Policymakers and regulators across the country are making the required changes to pension standards legislation that would recognize single-employer TBPs.
- Yet the current tax regime does not accommodate alternative pension plan designs such as single-employer TBPs. There is a clear need for more certainty about the tax treatment of these plans. In short, changes to the federal tax rules are needed to accompany the reforms.
- In this E-Brief, we have proposed a tax treatment for single-employer TBPs that is consistent with the existing tax regime.

Canada's shifting pension landscape is responding too slowly to financial pressures faced especially by private-sector employers. But the pace could be quickened to the benefit of employers and future pensioners provided governments showed appropriate leadership.

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Employers today are finding traditional defined-benefit (DB) plans too risky, since they are fully responsible for financing and paying out pre-determined pension amounts at a time when the economic and demographic environment is unfavorable. As a result, employer contributions are uncertain and can be onerous. One alternative is a defined-contribution (DC) plan, but the pension payout then depends on the amount of the contributions and how well they are invested. There is, therefore, no certainty to the pension amount.

There is a third alternative that could be more effective if not hamstrung by the current tax regime. Called target benefit plans (TBPs), they constitute an attractive hybrid of DB and DC plans in which employer and employee contributions are fixed (or variable within agreed upon parameters) to fund target pension payouts subject to adjustments depending on regular assessments of the sustainability of the TBP under a predetermined benefits/funding policy.

Some jurisdictions in Canada already permit single-employer TBPs and several others have taken initial steps to do so (Steele et al. 2014). In this E-Brief, we consider legal and regulatory changes that would allow TBPs to play an increasing role in meeting the needs of both employers and prospective pensioners.

A number of plans have moved to the TBP model over the past few years despite a lack of clarity in both tax and pension legislation in many cases.[1] Employers and employees are increasingly showing interest in learning about TBPs as a potential solution to their pension challenges in this difficult economic environment. However, uncertainty with respect to the tax treatment of these new designs hinders their broad adoption by prospective employers and their employees.

While pension legislation accommodating single-employer TBPs exists or is being developed in many Canadian jurisdictions, these plans must also be registered with the Canada Revenue Agency (CRA) under the *Income Tax Act* and accompanying regulations, which we will collectively refer to as the Tax Rules. Among the critical questions for future development of TBPs is their treatment under these Tax Rules. Do these rules require amendment to reflect the special nature of TBPs as distinct from other registered pension plans? The need for answers to such questions is pressing, not only to sponsors considering a TBP as a design option, but also for those TBPs already filed for registration with CRA.

Are TBP-specific Tax Rules needed? In our view, the short answer is yes.[2] The special nature of single-employer TBPs requires special tax treatment. The nature of the problem is the uncertainty created by an unspecified tax treatment. Clarity regarding the application of current Tax Rules to TBPs is required, along with specific rules for this type of plan.

We recommend a flexible and practical approach to address the shortcomings of today's Tax Rules as they apply to TBPs. Our approach is flexible because it contemplates the full spectrum of potential TBP designs (from those that seek to provide a highly stable benefit to those where the benefit might be expected to vary frequently).

1 For example, see the Regina Police Pension Plan – http://www.benefitscanada.com/pensions/other-pensions/regina-police-get-target-benefit-plan-53478 and the Resolute Forest Products pension plan – http://www.benefitscanada.com/pensions/cap/are-target-benefit-plans-a-pension-fix-for-Canada-34397.

2 This E-Brief focuses on single-employer TBPs. As set out in the Appendix, there is already a tax regime for specified multi-employer pension plans, although the proposals in this paper would also work for SMEPPs.

Our proposal is also practical because it supports the Tax Rules objective of limiting the tax sheltering of pension monies and because it is consistent with the existing pension tax regime.[3]

Single-Employer Target Benefit Plan Features

Key features of TBPs include a targeted pension payment formula (DB-type) for members at retirement, fixed (or variable within a certain pre-determined range) contribution requirements for both employers and employees, and a policy establishing the linkage between benefits and funding. TBPs are designed with the flexibility to adjust benefits to accommodate any funding/economic issues in a timely manner such as indexing or other benefit enhancements only when the plan can afford them, or reducing benefits in tougher economic times. The benefits/funding policy is used to promote long-term sustainability, cost and benefit stability and transparency for all stakeholders.

TBPs pool both investment and longevity risk, making them similar in this respect to DB pension plans. Pooling longevity risk means that participants don't have to worry about outliving their retirement savings, as is the case with DC pension plans or other capital accumulation vehicles such as Group RRSPs. For pension sponsors wanting cost certainty, the TBP's pre-determined contribution level or range offers a viable alternative to a capital accumulation vehicle.

Adjustable target benefits have existed for some time with multi-employer pension plans(Bauslaugh 2014). However, the requirement for a pre-determined policy for keeping benefits and funding in balance, a core metric of TBP design, is less common. In addition, subject to limited exceptions, TBPs are a new pension design for single-employer arrangements. New Brunswick was the first jurisdiction to introduce comprehensive target benefit legislation.[4] Currently New Brunswick is the only jurisdiction with pension legislation that permits retroactive conversion from DB to target benefit plans.[5]

Meanwhile, Alberta introduced target benefit enabling legislation that came into effect on September 1, 2014 with its new *Employment Pension Plans Act*.[6] Quebec allows TBPs only for certain companies in the pulp and paper sector, the assets of which are acquired subject to an order under the *Companies' Creditors Arrangement Act*.[7] In Saskatchewan, the pension regulator is of the view that target benefits are already permitted under its existing pension standards legislation.[8] Other jurisdictions are at various stages of accommodating single-employer TBPs.

However, all jurisdictions face uncertain treatment of single-employer target benefits under the current federal tax regime. This uncertainty may negatively impact TBPs' take-up in jurisdictions that currently allow them.

3 While arguments may be made for a more extensive overhaul of the registered pension plan tax regime, that is beyond the scope of this paper.

4 New Brunswick's *Pension Benefits Act* was amended in 2012 to include a new Part 2 for shared-risk plans. See Ch. P-5.1 and New Brunswick Regulation 2012-75.

5 TBPs in New Brunswick are known as shared-risk plans.

6 See SA 2012, c. E-8.1.

7 See *An Act to provide for the establishment of target-benefit pension plans in certain pulp and paper sector enterprises*, Bill 15, 2012, c. 32.

8 See S. 40 of the P*ension Benefits Act*, SS 1992, C. P-6.001.

The Tax Rules are designed to accommodate DB, DC and specified multi-employer pension plans (SMEPPs) found in unionized environments.[9] But these rules currently contain no provision for single-employer TBPs. Accordingly, single-employer TBPs have to somehow fit within the existing regime designed for more traditional plans. Clearly, this is insufficient to encourage TBPs as a potential solution to pension pressures.

To address their unique features, TBPs require distinct tax treatment, separate and apart from the regimes that apply to DB and DC plans. Based on the increasing number of TBPs being submitted for registration under the Tax Rules, these issues should be resolved as soon as possible so that all stakeholders have certainty regarding how TBPs will be treated for tax purposes. The federal government should quickly change the Tax Rules, as proposed in this E-Brief, to properly accommodate TBPs, thereby recognizing them as an important and distinct registered pension plan design.

Tax Treatment of Single-Employer Target Benefit Plans

TBPs do not fit well within the existing Tax Rules for a number of reasons that are outlined below.

Pension Adjustments

The Pension Adjustment, Past Service Pension Adjustment and Pension Adjustment Reversal regimes under the Tax Rules are designed to ensure that individuals can tax shelter only a certain amount each taxation year in retirement savings vehicles such as registered pension plans, registered retirement savings plans (RRSPs) and deferred profit sharing plans. These rules provide an integrated regime whereby an individual's RRSP contribution room is adjusted up or down based on pension credits earned in a registered pension plan.

Specifically, a Pension Adjustment (PA) is triggered when an individual earns a pension benefit under a registered pension plan. The individual's RRSP contribution room for the following year is reduced by the amount of his or her current year PA. For DC pension plans, PAs are based on the previous year's aggregate contributions made to DC plans, subject to certain limits under the Tax Rules. For DB plans, the PA is determined based on a general formula set out in the Tax Rules that converts the yearly-accrued pension benefit into a dollar equivalent so that it can be deducted from the following year's RRSP contribution limit.

The Tax Rules also include provisions for a Past Service Pension Adjustment (PSPA), in the event that an individual's DB pension earned in respect of past service is enhanced in specified ways (e.g., there is a retroactive increase to the member's lifetime DB benefits). A PSPA is essentially the deemed value of the past service enhancement. A PSPA will reduce the current and future amount an individual can contribute to his or her RRSP to ensure that the overall limit on tax-sheltered vehicles is respected.

Finally, a Pension Adjustment Reversal (PAR) is an amount that may restore an individual's RRSP contribution room when the actual value realized by a member of a registered DB pension plan is less than the total corresponding PAs and PSPAs previously attributed in respect of plan benefits. A PAR would generally apply to a DB plan member who terminates membership and receives a commuted value termination benefit that does not reflect the full value of past PAs and PSPAs.

9 See Appendix for further discussion on the Tax Rules applicable to SMEPPs and the impact of applying this approach to TBPs.

Strictly applying the DB rules related to PAs, PSPAs and PARs to TBPs would not be ideal given that benefits under TBPs may, by design, be subject to what, in most cases, will be temporary adjustments both during employment and in retirement. For example, if targeted base (lifetime) benefits are reduced during employment, how would this be addressed in terms of PARs? There is currently no PAR mechanism under the Tax Rules until termination of employment, and even then an adjustment is permitted only if the terminating member elects a lump-sum transfer rather than a deferred pension. There is also no mechanism under the Tax Rules to cover a pension that is adjusted when in payment. Furthermore, if the reduction is only a temporary reduction, should there be any impact on members' PAs or PARs?

Maximum Contributions

The Tax Rules limit the amount of tax-sheltered contributions that can be made to registered pension plans. For DC pension plans, the maximum annual contribution is tied to CRA's prevailing "money purchase" limit (in 2015 – $25,370).[10] By contrast, any amount of eligible contributions to a DB pension plan may be made on an actuary's recommendation that such monies are needed for the plan to have enough assets to pay the defined benefits. Essentially, whatever money is needed to pay the defined benefits will be allowed.[11] Moreover, if the DB plan is contributory,[12] there are restrictions as to the maximum employees may pay to fund benefits (9 percent of compensation for most plans), unless one can obtain a waiver under the Tax Rules.[13]

CRA's decision to treat TBPs as either a DB or DC plan when determining maximum contributions could result in inequitable and/or unnecessary limitations compared to other plan designs.[14]

Equal and Periodic Pensions

The Tax Rules provide that lifetime retirement benefits in DB plans must be payable in equal periodic amounts, subject to certain exceptions. In contrast, the very nature of TBPs is that benefits may be adjusted around the target to suit economic circumstances (i.e., potentially creating pensions that, while periodic, are not necessarily "equal"). The Tax Rules need to exempt these plans from the "equal and periodic" rule, or otherwise amend the rule.

Maximum Pensions/Benefits and Commuted Value Transfer Limit

The Tax Rules also set out maximum defined-benefit pension limits[15] and the maximum amount that may be transferred out of a DB plan on a tax-sheltered basis when a member terminates employment and elects

10 The money purchase limit is set out in subsection 147.1(1) of the *Income Tax Act* (ITA). It is the upper limit for permissible contributions to a defined-contribution plan.

11 The Tax Rules prescribe the maximum DB pension a person can accumulate under a registered plan in a given year.

12 Employees are required to contribute to the plan in addition to the employer.

13 See *Income Tax Regulations* (ITR) 8503(5).

14 Since the introduction of the factor-of-nine rules in the early 1990s, there has been significant controversy regarding its appropriateness as a basis to calculate PAs for DB pension plans with different benefit levels. For practical reasons in this E-Brief, we focus on suggestions for TBPs that fit within the existing tax regime.

15 The Tax Rules prescribe the maximum DB pension a person can accumulate and receive under a registered plan in a given year.

portability (commuted value transfer) to another plan. If these DB rules apply to TBPs, then it would have to be clear which benefits are to be included for purposes of determining these limits. That is, are all benefits permitted or contemplated under the TBP and its benefits/funding policy terms to be included in the calculation?[16] Furthermore, if contributions are less than the defined-contribution limits, should limits be applied to benefits?

Maximum Liability Test / "Excess" Assets

The Tax Rules limit the amount of excess assets that can be retained in a DB plan – before certain restrictions apply – to 25 percent of the value of the actuarial liabilities. The test is applied whenever an actuarial valuation report is required to determine maximum permitted employee and/or employer contributions. When there are excess assets (i.e., greater than the 25 percent) in a plan, absent withdrawal or permitted benefit enhancements to reduce such excess, the Tax Rules effectively prevent further employer contributions until the amount of excess assets comes down to permissible levels. In other words, the Tax Rules impose forced contribution "holidays."

If this limitation on plan funding were also to apply to TBPs, then it would be necessary for the Tax Rules to specify which benefits must be included in the valuation of actuarial liabilities for testing purposes; i.e., target or actual benefits? When and how should ancillary benefits be included? To what extent is an explicit contingency reserve part of the actuarial liability or part of the excess assets?

Tax Treatment Options for Target Benefit Plans

Rather than trying to make TBPs fit either the DB or the DC tax moulds under the current Tax Rules, we believe that the rules should be revised on the following basis. We first recognize that the typical target benefit model is one that operates as both:

- "**DC in**" – contributions are fixed (or variable within a narrow pre-determined range), as in a traditional DC plan; and
- "**DB out**" – funds are pooled, risk is shared and benefits are provided according to a formula, as for a traditional DB plan, but without the benefit "guarantees" of DB.

Recognizing also that actual target benefit designs may vary considerably depending on the applicable pension standards legislation and the preferences and history of the parties involved, we propose that the Tax Rules be modified to accommodate two alternative approaches.

- **Alternative 1** – A default DB approach, which applies the tax rules applicable to DB pension plans, with some modifications; or
- **Alternative 2** – A DC approach, which applies the tax rules applicable to DC pension plans, with some

16 For example, if the target benefit started at 1.5 percent of pay per year of service, but could be increased up to 2 percent of pay, if funding permitted, would the benefit used to determine the maximum transfer limit be the maximum possible benefit or the current benefit?

modifications. This alternative DC approach is contemplated only where contributions under the TBP are limited to no more than 18 percent of compensation.[17]

The DB approach would apply by default, unless the CRA has accepted a one-time application for treatment under the alternative DC approach at plan inception or conversion.

The default DB approach would be suitable for TBPs where:

- The design focus is on the target base-benefit formula, with a very low expectation that the formula for all service will ever require adjustment up or down;
- The plan is converting to target benefit from defined benefit; and/or
- The TBP will provide a benefit that could require contributions in excess of 18 percent of compensation.

The alternative DC approach would be suitable for TBPs where:

- The primary design focus is on fixed contributions, with very low expectation that the contribution rate will ever change or where there is a reasonable expectation that the base benefit formula could be adjusted;
- The TBP is created through conversion from a DC pension plan or SMEPP; and/or
- The TBP will provide a steady contribution rate that will never exceed 18 percent of compensation.

The impact of this two-pronged approach is minimal modification to the Tax Rules required to accommodate TBPs. Specifically, our suggested approach would require the following minor changes.

1. Pension Adjustment

As discussed above, the PA, PSPA and PAR rules are designed to ensure that individuals can tax shelter only a certain amount each taxation year in all tax-sheltered retirement savings vehicles.

Under the default DB approach, pension adjustments would be calculated based on the defined-benefit PA formula using the target base (lifetime) benefit. The pension adjustment reversal would continue to be equal to the historical PAs less the actual commuted value transferred. A past service pension adjustment, either positive or negative, would be generated only if the targeted base (lifetime) benefit is permanently adjusted. If there is a temporary benefit adjustment, no PSPA would be generated. To accommodate these changes, the Tax Rules would have to be amended to specify that negative PSPAs are permitted and would have to require the use of the target base benefit in all PA/PSPA/PAR reporting.

Under the alternative DC approach, the pension adjustment would be equal to contributions remitted by and on behalf of each member in a calendar year, similar to the Tax Rules applicable to DC pension plans and SMEPPs. A pension adjustment reversal mechanism would be needed as the benefit is calculated based on the target formula. If a member's benefit is paid as a lump sum transfer, the PAR would be equal to the excess, if any,

17 This is based on the assumption that the 18 percent of compensation remains as the relevant DC limit under the Tax Rules. There are arguments for increasing this limit so that it is high enough to ensure that participants in all forms of retirement vehicles have equal lifetime tax-sheltered accumulation opportunities, and permit a comfortable level of income replacement, but a discussion of this issue is beyond the scope of this E-Brief.

of the member's historical PAs over the actual commuted or termination value transferred. Changes to the Tax Rules would be required for this PAR calculation and reporting mechanism. PSPAs would be treated the same as DC plans – i.e., there would be no PSPA. An exception would be required where the target benefit plan allows for a service buy-back, in which case the PSPA could be equal to the contributions required for the buy-back.

2. Maximum Contributions

Under the default DB approach, employee-required contributions could exceed 9 percent of compensation, without entailing a waiver,[18] where (i) employer contributions equal or exceed employee-required contributions, or (ii) the applicable pension standards legislation exempts the plan from the 50-percent-employer-cost rule. As provided under current DB plan Tax Rules, total TBP contributions would have to be supported by an actuarial valuation and meet the other requirements subject to the proposed change to the excess assets rule discussed below.[19] Amending the Tax Rules to exempt TBPs from the waiver requirements would simplify administration of these plans.

Under the alternative DC approach, plan contributions by and in respect of each member would be limited to the lesser of 18 percent of compensation or the CRA's money purchase limit for the year.

3. Equal and Periodic Pensions

The Tax Rules permit specified payments from a defined-benefit provision of a pension plan.[20] Under both the default DB and alternative DC approaches, the Tax Rules would have to be amended to permit a TBP to pay a retirement income stream. In addition, the Tax Rules must be amended to add an exemption for a TBP when the stream is reduced or increased as a result of the plan's benefits/funding policy.[21]

4. Maximum Pensions/Benefits and Commuted Value Transfer Limit

As discussed above, the Tax Rules set out maximum limits for DB pension plans and rules regarding the maximum amount that may be transferred out of such a plan on a tax-sheltered basis when a member terminates employment and elects portability. Under the default DB approach, the maximum benefits and transfer limits applicable to DB pension plans would be applied to TBPs.[22] Amendments to the Tax Rules would be required to specify that all potential benefits under the TBP and benefits/funding policy are to be used to determine the maximum benefit limits.

As the alternative DC approach is similar to the tax treatment for DC pension plans, no amendments would be required to the Tax Rules: the contributions would be limited and, therefore, the limits to benefits and transfers would not apply.

5. Maximum Liability Test/Excess Assets

Under both the default DB and alternative DC approaches, a test would be required with every actuarial valuation

18 Under ITR 8503(5).

19 See ITA 147.2(2).

20 See ITR 8503(2).

21 See ITR 8503(2)(a).

22 In this regard, the Tax Rules will have to recognize that the benefits/funding policy for TBPs is an integral document that is read together with the plan text.

report to verify an appropriate balance between benefits and funding. The purpose of the test would be to ensure that TBPs don't hold too much in reserves or pay too little in benefits. In other words, there would be a limit on the held funds that can be tax sheltered under the TBP. For the purposes of determining the actuarial liability under this test, the plan value would include all potential benefits described in the plan and the benefits/funding policy based on service accrued to date, including appropriate safety margins.[23] If the assets exceed the determined actuarial liability, they would be permitted to do so by the current margin of up to 25 percent. Any reserve above 25 percent would be considered "excess assets." The application of any such excess assets would be restricted to the following uses:

- Improvement of benefits;
- Reduction of contributions; or
- Payment of an immediate, taxable cash distribution.

However, some TBPs may require a higher margin than 25 percent to maintain benefit stability in volatile economic environments (i.e., reducing the need to lower benefits following an increase that turned out to be unsustainable). We propose that a TBP be permitted to qualify for a higher reserve by satisfying CRA that it is needed.

Conclusions

Based on our collective experience, many plan sponsors are looking, or have been looking, for alternatives beyond traditional pension arrangements to better manage their pension risks. TBPs are a different pension vehicle than DB and DC plans, and policymakers and regulators across the country are making the required changes to pension standards legislation that would recognize them.

Yet the current tax regime is not designed to accommodate alternative pension plan designs such as single-employer TBPs. As pension standards legislation across the country evolves to accommodate the target-benefit approach, there is a clear need for more certainty about the tax treatment of these plans. In short, changes to the Tax Rules are needed to accompany the reforms.

In this E-Brief, we have proposed a tax treatment for single-employer TBPs that is consistent with the existing tax regime. Ideally, the changes should include the default DB and alternative DC approaches discussed above. Short of that, and if changes to the Tax Rules are not forthcoming, CRA should provide definitive guidance regarding the tax treatment of single-employer TBPs under the current regime.

TBPs may not be appropriate for every workplace. However, at the very least they comprise an important alternative pension design. As discussed above, like DB plans, TBPs pool longevity and investment risk and provide lifetime income security through a targeted DB-type pension at retirement. They provide a pension, as opposed to a savings account. More and more plan sponsors are exploring TBPs as an alternative, and more and more jurisdictions are acknowledging their potential by making much-needed regulatory change. Now, it is time for the federal government to follow suit. We encourage Ottawa to amend the Tax Rules to address the evolving Canadian pension landscape.

23 For greater certainty, this would include the maximum of target benefits, as described in the TBP text and benefits/funding policy, and current benefits, subject to the maximums applicable to DB plans under the Tax Rules if the default DB approach is applied.

APPENDIX – Why not Simply Expand the SMEPP Rules?

Some industry experts might ask why our Tax Rules recommendations do not include a simple expansion of the rules for Specified Multi-Employer Pension Plans (SMEPPs) to embrace target benefit plans (TBPs). This is a valid question deserving consideration.

SMEPPs, typically found in a unionized environment, receive recognition under the Tax Rules as a hybrid of defined-benefit (DB) and defined-contribution (DC) plans. Under the rules for SMEPPs, the DB limits, for the most part, apply to benefits, while the DC contribution limits apply to the contributions.

Pension Adjustments (PA) are based on the contributions made to the SMEPP. This provides certainty in terms of calculating PAs and permits the SMEPP to make necessary benefit adjustments when there is a surplus, or even cutbacks, without complicated Past Service Pension Adjustment (PSPA) reporting.[24]

While it might seem initially attractive to expand the SMEPP treatment to TBPs, there are issues that suggest this approach would be inadequate compared to a TBP-specific solution:

- A DB plan with the maximum 2 percent final-average-earnings benefit formula could easily require service costs in excess of 18 percent of pay (the maximum DC contribution). Restricting TBP contributions to 18 percent to comply with the DC contribution limits could handicap plan members from attaining the best benefit supported under the Tax Rules and would particularly impact those who are moving to a TBP from a DB plan. (As an aside, this highlights the fact that the balance in DB and DC tax rules introduced in 1990 is seriously inconsistent with today's economic environment.) Benefits under the traditional SMEPP typically don't come close to approaching the maximum level permitted by the Tax Rules under a DB plan. Therefore, to date, the DB/DC imbalance in the Tax Rules has not been an issue for SMEPPs.
- Recently implemented TBPs (in Quebec, New Brunswick and Saskatchewan) have involved conversions of existing DB plans. As a result, these new TBPs have been applying the DB tax rules in determining PAs. All of these plans have had a strong focus on benefit stability – in other words, they are more like DB plans than DC plans. Furthermore, to attain sustainability of the target benefit, such plans have incorporated long-term reserves into their contribution levels. If PAs were to be based on contributions, then members would have their PAs adjusted for these reserves, and such PAs could prove to be in excess of the benefits actually received. In addition, the contribution could be in excess of the PA limits at times, and it is unclear as to whether and how this might impact benefit accruals.

24 SMEPPs are not "fully exempt" from PSPAs, but the usual rules for determining PSPAs for benefit upgrades do not apply to SMEPPs, as SMEPP pension credits are calculated on a contribution basis, similar to DC plans. The member's annually reported PA reflects any post-service benefit upgrades funded with contributions made by the employer – which are at the negotiated rates – so the PA method picks up the cost for benefit upgrades. Some SMEPPs allow members to top up part-time years, for example, with member contributions. When a member makes a contribution under a SMEPP for past service benefits, a past-service event occurs. The PSPA will usually equal the member's past service contribution. This includes any contributions the member made that are conditional on certification of the PSPA. The PSPA must be certified by Canada Revenue Agency before the related benefit can be paid to the member. A past service contribution by a member does not include: i) contributions included in the member's pension credit under the plan for the year; or ii) tax-free transfers into the plan (tax-free transfers are qualifying transfers for purposes of PSPAs – e.g., transfer from an RRSP). All PSPAs from SMEPPs must be certified unless less than $50. There is no PAR for an individual who terminates membership under a SMEPP.

Finally, there is one key difference between SMEPPs and TBPs that has not yet been mentioned. A SMEPP bases its contributions on rates negotiated between employers and employee groups. Once the rates are negotiated, they are fixed until the next round of negotiations. A TBP also bases its contributions on agreed-upon rates, but typically for much longer than just the length of a collective bargaining agreement. In addition, a TBP design can include flexibility in the contribution rate. In New Brunswick, for example, contributions can be reduced or increased (within a narrow pre-determined range), if plan funding permits.

The question therefore arises: if PAs are based on contributions and contributions are reduced – for the sake of argument, suppose there could even be a contribution holiday – then could a member still accrue a benefit while the PA is half the value of the accruing benefit, or even zero?

In considering this issue, we examined the following pros and cons of fitting TBPs into one or the other of the DB and DC tax regimes:

- It would be attractive to consider TBPs as DC plans as the PA administration is much simpler. However, there are plans that might wish to convert where contributions are currently greater than 18 percent of members' compensation. Trying to accommodate the rules to allow contributions in excess of 18 percent creates several complications. In addition, younger members could receive a benefit much lower than their PAs, with no adjustment to RRSP contribution room. Finally, if contributions are reduced, then the PA might not reflect the value of the benefit earned in a year.
- If TBPs are treated as DB plans, then, given the variable nature of the benefit, there is an increased likelihood of complicated PSPA and Pension Adjustment Reversal (PAR) calculations resulting from benefit changes, not all of which are provided for in the Tax Rules. For example, benefits could be adjusted in retirement. Also, there is no adjustment mechanism if the benefit is reduced, as negative PSPAs are not contemplated and PARs are not calculated unless the member chooses a lump-sum transfer. In addition, applying the DB rules limits the potential design of TBPs, forcing them to look like a DB plan. While this may be acceptable for early conversions, we foresee difficulties as plan designs continue to innovate.

We, therefore, conclude that the Tax Rules applicable to TBPs need to be more flexible and should give the TBP the choice of coming under a "Default DB" or an "Alternative DC" approach.

The impact of this two-pronged recommendation is that modifications to existing Tax Rules required to accommodate TBPs are considerably fewer.[25]

25 As noted above, there are many arguments for an overhaul of the registered pension plan tax regime. However, that is beyond the scope of this E-Brief. We have attempted to construct a potential tax regime for single-employer TBPs that would fit within the existing rules, with minimal modification.

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