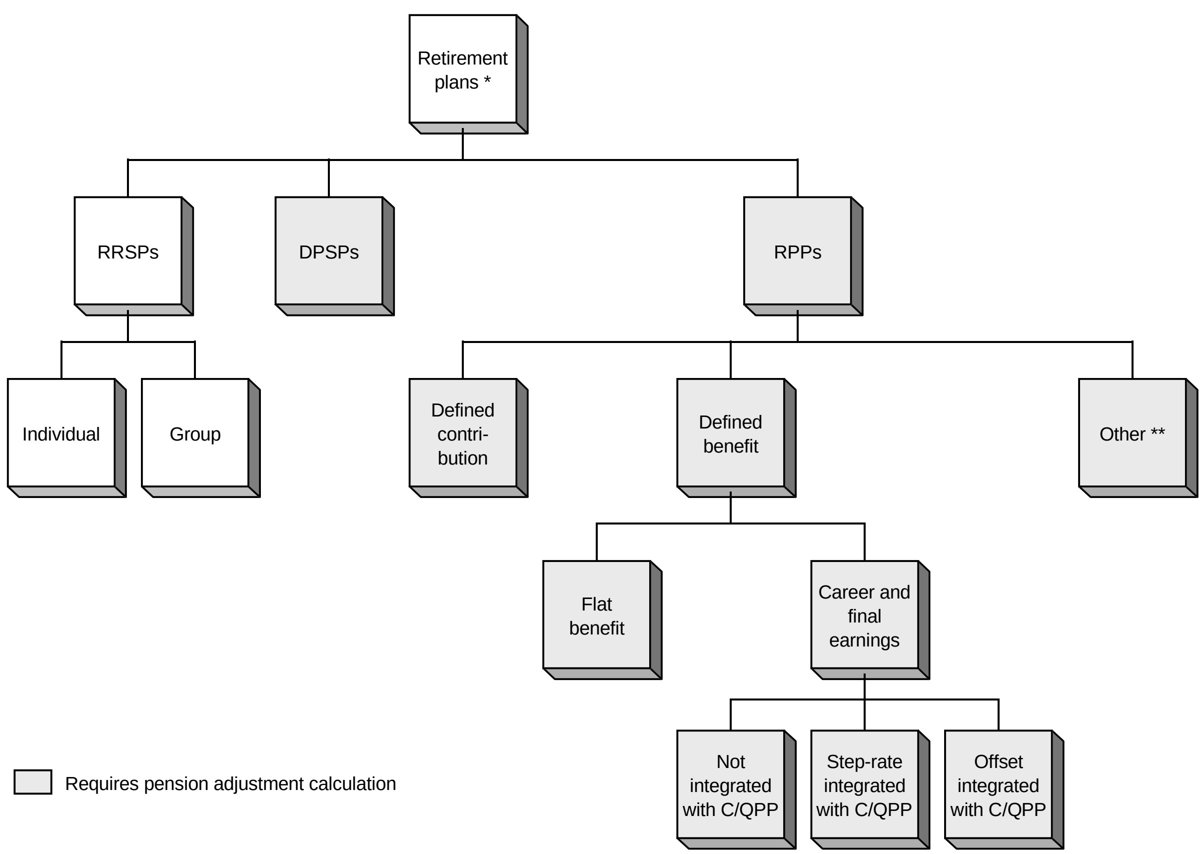
Tax assistance for pensions and RRSPs

Hubert Frenken

The tax treatment of retirement savings changed dramatically in 1991. "[T]o provide fairer and more flexible limits on tax assistance" (Department of Finance, 1988), new legislation sought to provide uniform, comprehensive limits on savings in all tax-assisted, non-government retirement programs (Figure): employer-sponsored registered pension plans (RPPs), deferred profit sharing plans (DPSPs) and registered retirement savings plans (RRSPs).

The previous legislation, while stipulating limits on the savings that workers could accumulate in RPPs, DPSPs and RRSPs, made little attempt to harmonize the tax treatment of these plans. It did impose two ceilings for annual RRSP contributions: one for persons who participated in an RPP or DPSP and one for those who did not. However, it was thought to have "serious inequities ... [leaving] taxpayers at the same income level with quite different opportunities to save for retirement" (Department of Finance, 1989a) because widely varying benefit levels generated by RRSPs, DPSPs and different types of RPPs were largely ignored.

Figure
Tax-assisted retirement savings programs in Canada



* *See* Data source and definitions.
** *Combination of defined contribution and defined benefit plans, and other hybrid arrangements.*

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Data source and definitions

The Revenue Canada RRSP room file provides data on all taxfilers with 1991, 1992 and/or 1993 tax returns. The 1993 data are preliminary and exclude returns not yet submitted or processed when the file was produced (approximately 1% of all returns).

A 2% sample file was used. Comparisons of selected tabulations with the entire file indicate similar results.

Annual data on each taxfiler include total income, earned income, pension adjustment, past service pension adjustment, RRSP room, and RRSP and employee RPP contributions, as well as age, sex and province or territory of residence.

These data, in conformity with the provisions of the Statistics Act, are available only at the aggregate level in order to ensure confidentiality. This limitation notwithstanding, a wide variety of statistics is available on a cost-recovery basis through Karen Maser, Chief, Pensions Section, Labour Division, Statistics Canada at (613) 951-4033.

Earned income is the income qualifying for RRSP purposes: net income from employment (both paid work and self-employment), rental property, alimony and maintenance arrangements and certain disability or loss-of-income plans, less some employment expenses such as union dues and alimony and maintenance payments.

Pension adjustment (PA) is a measure of pension credits earned during the year under an RPP or a DPSP, which reduces RRSP room in the subsequent year. It is calculated differently for each type of RPP and for DPSPs. In the companion article, "Who's saving for retirement?" it is used as a proxy for pension savings.[1]

Past service pension adjustment (PSPA) measures pension credits accrued through the "buyback" of pensionable service or by retroactive improvements in pension benefits for any period since January 1990. It also reduces RRSP room.[2]

RRSP room is the deduction limit or maximum RRSP contribution amount the taxfiler can claim in any year. It is calculated by Revenue Canada based on earned income, PA, PSPA and unused room carried forward.[3]

Registered retirement savings plans (RRSPs) are personal savings plans for which contributions are tax-deductible within certain limits and investment income is tax-exempt. Only benefits paid or withdrawals made from these plans are taxable. RRSPs can be individual or group arrangements. Under group RRSPs, a single trust or contract is established on behalf of employees or for members of a professional or trade association and contributions are pooled. Individual RRSP contracts must be registered for each participant, however, and separate accounts must be kept.[4]

Deferred profit sharing plans (DPSPs) permit employees to share in company profits. Employer contributions, either a percentage of profits or a fixed dollar amount, are set aside in a fund. A separate account is maintained for each member, credited with investment income and paid out at the employee's death, retirement or termination.[5]

Registered pension plans (RPPs) provide retirement pensions (and often disability and death benefits). They specify an age of eligibility for retirement pensions, including conditions for early retirement. There are two types: defined contribution and defined benefit. The former specifies an employer contribution rate and (if required) employee contributions, but not the benefit formula. The latter defines the amount of benefit the retiring member will receive, but usually not the employer contributions. The employer contributes as needed to ensure that funds meet expected pensions.[6] (A small number of RPPs have combination or hybrid formulas.)

Defined benefit formulas vary considerably. They may be flat benefits, paying a fixed monthly pension not related to earnings; career earnings, providing a percentage of average earnings from all years of plan participation; or final earnings, granting a percentage of the members' earnings during a specified period just before retirement.

Most members of career and final earnings plans have a benefit formula that takes into consideration pensions paid under the Canada and Quebec Pension Plan (C/QPP integration).

For more information on the various plans, on C/QPP integration and on the different rates of accrual of retirement savings, consult Frenken (1995a).

This article shows how current tax-assistance rules apply to members of different plans, how the levels of tax-assisted savings can vary widely and how these savings are integrated. It also notes the number of persons falling into the various tax-assistance categories. Along with the next two articles in this issue it uses data from the new Revenue Canada RRSP room file. For definitions of terms and concepts common to all three, see *Data source and definitions*.

New analytic tool

The RRSP room file contains 1991-to-1993 personal income tax information that makes it possible, for the first time, to analyze the extent to which individuals have been saving for their retirement through each of the programs, and which combinations were used over a three-year period. Previously, participation in each program could be studied only independently, and for just one year at a time. RRSP analysis was limited to defining the characteristics of taxfilers most likely to contribute in a given year. This file, however, permits the description of those who maximize their RRSP opportunities on a regular basis, those who contribute intermittently and those who never participate.

Table 1
Current schedule of dollar deduction limits for RPPs, DPSPs and RRSPs

	RPPs	DPSPs	RRSPs
		$	
1995	15,500	7,750	14,500
1996	13,500	6,750	13,500
1997	14,500	7,250	13,500
1998	15,500	7,750	14,500
1999	indexed *	indexed *	15,500
2000	indexed *	indexed *	indexed *

Source: Finance Canada
* *Limits are indexed to changes in average wages and salaries.*

The file will be augmented annually, providing a longitudinal database. As more data are added, it will be possible, for example, to evaluate any effect the recession of the early 1990s may have had on RRSP participation and contribution levels.

New deduction limits

The 1991 legislation set new ceilings for annual savings in RPPs, DPSPs and RRSPs.[7] RPP/DPSP savings are limited to specific dollar amounts (DPSPs at one-half that of RPPs), while RRSP contribution ceilings are either a dollar amount or 18% of earned income, whichever is lower.[8] The RRSP deduction limit still depends on the taxfiler's participation in an RPP or DPSP the previous year. For these participants the RRSP room is reduced by the pension adjustment (PA), a calculated value of the annual pension credits provided by the RPP or DPSP.

Dollar amounts

The annual dollar limit was initially set at $11,500 (for RPPs in 1990 and for RRSPs in 1991[9]) and scheduled to increase each year by $1,000 until reaching $15,500, before being indexed to average wages and salaries. A pension from contributions at this level over a full career was considered comparable to the maximum benefit from a defined benefit RPP. The original schedule was changed in the 1992 and 1995 budgets and is currently projected to reach $15,500 by 1998 for RPPs and 1999 for RRSPs (Table 1).[10]

Greater flexibility

Taxfilers who do not use their annual RRSP room no longer forfeit the opportunity: since 1991, unused room may simply be carried forward. This provision would permit, for example, a taxfiler with RRSP room of $10,000 but able to contribute only $2,000, to have the remaining $8,000 added to the room available for the next year. The implications of this provision are significant, because aggregate unused room has been growing at a dramatic rate (see "RRSPs – unused opportunities" in this issue).

Pension savings

The PA calculation, striving for fairness and seeking to reflect contributions, varies from plan to plan. For members of a DPSP or defined contribution RPP, the PA consists of total employer and employee contributions during the year. For example, a worker earning $40,000 per year and participating in a typical defined contribution RPP, requiring contributions of 5% of earnings by both employee and employer, would have a PA of $4,000. A DPSP member whose employer contributed $2,000 into a profit sharing fund would have a PA of $2,000.

For defined benefit RPP members, employer contributions cannot be quantified as easily. They may fluctuate from year to year, depending on the financial position of the plan. (In fact, in a specific year the employer may have been excused from contributing altogether, because of a surplus in

Table 2
Membership* in RRSPs, DPSPs and different types of RPPs, 1993

	Members
	'000
RRSPs	5,110
DPSPs	350 **
RPPs	5,245
Defined contribution	460
Flat benefit	891
Non-integrated career and final earnings	434
Step-rate integrated career and final earnings	2,510
Offset integrated career and final earnings	791
Other †	159

Sources: RRSP room file, Revenue Canada, and Pension Plans in Canada database
* *See* Data source and definitions. *Workers may belong to more than one plan during the year.*
** *DPSP membership is estimated, based on data obtained from Revenue Canada, Registered Plans Division.*
† *This includes RPPs with different formulas for different categories of members, a combination of formulas, and other hybrid arrangements.*

Some remaining differences

The 1991 legislation made the tax treatment of retirement savings much more equitable, although it did not manage to eliminate all situations that provide advantages for some individuals, largely because of the effect of the PA on RRSP room. Workers with the same earned income, the same PA and the same remaining RRSP room may still accumulate different levels of retirement and supplementary benefits. Some examples of these situations follow.

Career versus final earnings

Even though pensions based on earnings close to retirement are generally much higher than those using average career earnings, the same pension adjustment calculation is used. (However, some employers with career earnings plans periodically update their earnings base. The number of members affected by these upgrades is not known.[12])

Bridging benefits

Many defined benefit RPP beneficiaries are paid a supplementary benefit from the time of retirement until age 65, formerly the earliest age for C/QPP retirement pensions.[13] This supplement or "bridging benefit" is not considered when pension entitlements and PAs are determined. Nearly three-quarters of members of C/QPP integrated plans are able to retire with an unreduced pension plus a supplement before age 65; in most cases the member is paid a full benefit without the C/QPP integration until then (Frenken, 1995a). The PA, however, is based on the benefit payable at age 65, resulting in a relatively lower PA and higher RRSP room.

Other ancillary benefits

Many defined benefit RPPs provide such supplementary benefits as indexing and survivors' pensions, not included in the calculation of the PAs.[14] In 1993, nearly 2.2 million RPP members had some form of automatic indexing of their future retirement pensions, and for almost 700,000 of these the pensions were to be adjusted annually to the full increase, if any, in the consumer price index (CPI). Furthermore, 1.7 million workers participated in plans that, in addition to their normal retirement pensions, provided survivors' benefits for their spouses.

Early termination

In a highly mobile labour force, many workers leave pension plans before retirement, often losing significant benefits. With continuous participation the value of RPP benefits earned during any membership period continues to grow to retirement (particularly in a defined benefit RPP).[15] Therefore, these benefits are generally much greater than the compensation provided on early termination, whether they are lump sum returns of contributions or a deferred pension payable at retirement. The pension adjustments charged against the member's RRSP room during the years of participation reflected such projected growth in RPP benefits. Yet no replacement of RRSP room is provided to compensate for the lower benefits. The Canadian Institute of Actuaries has estimated that benefits payable on termination are often worth less than 20% of the RRSP room the worker has forgone by participating in a pension plan (CIA, 1995).[16]

the pension fund.) Therefore, the PA is calculated using the following formula:

nine times the pension entitlement, less $1,000,

where the pension entitlement is a calculated value of pension savings credited to the member during the year.

This calculation, which uses the plan's benefit formula, varies for each type of defined benefit RPP. (For information on the role of the formula in calculating annual benefit costs see Revenue Canada, 1993). For a worker earning $40,000 with a typical flat benefit of $30 per month for each year of service, the PA would be $2,240. A 2% non-integrated career or final earnings formula would produce a PA of $6,200.[11] For the most part, the more generous the promised pension, the higher the PA. Nevertheless, some inequities still exist (see *Some remaining differences*).

Varied membership

How many taxfilers participate in each type of retirement plan? While 5.1 million persons contributed to RRSPs in 1993, only about 350,000 participated in a DPSP[17] and 460,000 belonged to a defined contribution RPP (Table 2).

At the same time, over 4.6 million individuals belonged to defined benefit RPPs: nearly 900,000 with a flat benefit formula and 3.7 million with a formula based on earnings (career or final earnings). For most members with an earnings-based formula, benefits were integrated with C/QPP pensions, most frequently using a step-rate benefit formula (Frenken, 1995a).

Summary

The rules governing tax assistance for retirement savings changed dramatically in 1991. The new legislation levelled the playing field for workers belonging to different types of retirement plans by introducing a pension adjustment (PA) for members of employer-sponsored registered pension plans and deferred profit sharing plans.

PA amounts vary widely, partly because some types of retirement plans tend to produce much higher PAs than others. Although some provisions that affect benefit levels are not considered in PA calculations (in particular, those relating to bridging benefits, indexing and survivors' benefits), generally the greater the accumulation of pension credits, the higher the PA and, as a consequence, the lower the RRSP contribution opportunity. Conversely, the sparser the pension savings, the greater the amount of tax assistance available through RRSPs.

The extent to which taxfilers are taking advantage of these opportunities is analyzed in the next two articles in this issue. The first deals with combined pension and RRSP savings and the second looks at the use of available RRSP room.

The authors of this and the following two articles wish to thank Edwin Williams, Programs Officer, Individual Returns and Payments Processing Directorate, Revenue Canada; and Ken Pawulski, Director, Pension Advice Section, Office of the Superintendent of Financial Institutions, for their valuable comments and suggestions.

Notes

1 The PA is calculated annually by employers and reported by taxfilers on their tax returns. Taxfilers with more than one PA (participation in more than one RPP/DPSP during the year) must report the combined amounts.

2 PSPAs must be reported by employers to Revenue Canada as they occur, resulting in adjustments to the taxfilers' RRSP room.

3 Taxfilers may also transfer certain types of eligible income into RRSPs without incurring a tax liability. From 1989 to 1994, as a transitional measure, taxfilers could roll over up to $6,000 of periodic payments from RPPs and DPSPs into spousal RRSPs. They may still roll over retiring allowances into their own RRSPs, up to certain limits.

4 Unlike RPPs, group RRSPs do not require employer contributions, although employers may contribute. These contributions are treated as employees' earned income for income tax purposes, however.

The number of group RRSPs and their participants, although not known, has been growing rapidly in recent years. Some employers have established group RRSPs in lieu of RPPs (Frenken and Maser, 1992).

5 Unlike members of RPPs, DPSP participants may receive lump sum distributions from their plans on retirement. (Pension regulatory legislation prohibits RPP lump sum payments.) To avoid tax deduction at source, members have the option of transferring the amounts to an RRSP or other registered plan, or purchasing an annuity.

6 Employer contributions to RPPs are not available from these data. Three out of ten RPP members either had plans not requiring personal contributions or elected not to contribute.

7 The opportunity to contribute to a spousal RRSP and yet claim these contributions against the taxfiler's own deduction limit was continued. The definition of spouse was expanded in 1993 to include common-law relationships.

8 The 18% of earnings approximates the amount required to replace pre-retirement earnings for most workers. It corresponds to the maximum benefit obtainable by a member of a defined benefit RPP with a formula of 2% of final earnings for each year of service. After the maximum period of contributory service (35 years), a member would be entitled to 70% of those earnings, "considered to be sufficient to avoid serious disruption of living standards" (Department of Finance, 1989a).

9 Current RRSP room is always dependent on the previous year's earned income, and the pension adjustment used to reduce each year's RRSP room is based on the previous year's RPP/DPSP participation.

10 Average wages and salaries have increased more slowly than expected. The earnings limit to which the 18% rate is applicable is targeted at 2.5 times average wages and salaries, or currently about $75,000. Eighteen percent of $75,000 is $13,500, the RPP ceiling for 1996 and the RRSP contribution limit for 1996 and 1997.

11 C/QPP benefit integration reduces the PA. With a step-rated formula of 1.3% of earnings up to the year's maximum pensionable earnings, and 2% on the balance of earnings, the PA would be just over $4,000. For an offset formula of 2% of earnings less the full C/QPP pension, the PA would be just under $4,000. The actual reduction would be one thirty-fifth of the C/QPP pension times the number of years of service. For further information on C/QPP integration see Frenken (1995a).

12 This is one of the reasons for treating career earnings and final earnings plans alike. It also avoids the need for burdensome PSPA calculations (see note 2) with each adjustment that might discourage some employers from making changes and improving members' pensions.

13 Since the mid-1980s C/QPP retirement pensions have been made available as early as age 60, albeit at a reduced level. The RPP supplementary benefits have not been lifted, however.

14 Many employers sponsoring RPPs with no automatic indexing provide increases in retirement benefits on an ad hoc basis. There are no data on how many pensioners receive such increases each year.

15 These benefits may profit from salary increases, plan improvements and benefit indexing.

16 This issue may be addressed soon, as stated in the 1995 budget: "The government will investigate the possibility of modifying the RRSP limits ... to restore lost RRSP room to employees who leave pension plans before retirement" (Department of Finance, 1995).

17 There are no complete data on the number of workers who participated in DPSPs. This estimate is based on limited data obtained from Revenue Canada.

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