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Newsletter

Supplemental Pension Plans

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The Member-Funded Pension Plan

Around 500 000 Québec workers in the private sector are members of defined benefit pension plans. It is mostly large companies that offer that type of plan, for which ensuring full funding is the employer's responsibility.

In recent years, some employers have expressed an unwillingness to assume the financial risk of a defined benefit plan. On the other hand, labour organizations have emphasized the need for membership in a defined benefit plan to build up a retirement pension, even if an employer is unwilling to assume the financial risk.

Until now, it was not possible under the *Supplemental Pension Plans Act* to meet the need expressed by workers. The only possibility was to participate in a defined contribution pension plan or a capital accumulation plan (group RRSP, deferred profit sharing plan and other retirement schemes). In those plans, the amount of the retirement pension is not known in advance and the members assume the financial risk, on an individual basis.

For that reason, legislative amendments have been made to allow the creation of a new kind of defined benefit plan, the **member-funded pension plan** (MFPP). In this new plan, the financial commitment of the employer is predetermined. It is the members who assume the financial risk, but collectively rather than individually. To take into account their limited capacity to support a plan's financial risk, stricter funding rules are imposed.

The MFPP is allowed under the *Regulation respecting the exemption of certain categories of pension plans from the application of provisions of the Supplemental Pension Plans Act*, which allows for the specific provisions for such plans to be made.

This issue of the *Newsletter* is intended to provide plan sponsors and administrators with information that will allow them to properly establish and administer an MFPP.

1. Administrator and members

The *Regulation* does not provide for any particular measures with respect to plan administration. Therefore, an MFPP that has more than 25 members and beneficiaries must be administered by a pension committee, in accordance with the *Act*. The plan text must specify the number of pension committee members as well as the conditions and time periods that apply for their designation and replacement.

An MFPP is primarily for unionized workers. Under tax rules, "An MFPP must be maintained pursuant to a collective bargaining agreement, unless the Minister of National Revenue waives this condition."[1] Consequently, if non-unionized workers want to establish an MFPP, or if, in addition to unionized workers, a plan will allow some non-unionized workers to join, an exemption must be obtained from the Minister of National Revenue.

It is expected that such an exemption will be granted "only for broad-based arrangements."[2] Put more precisely, this means that a plan established for the majority of workers in an organization would, in principle, be exempted, but that a plan established mainly for key employees would not be exempted.

2. Establishment of an MFPP

The *Regulation* does not specify who may establish an MFPP. Thus, an employer may establish one for its employees. However, because of the nature of the MFPP, it is to be expected that a labour union, which may in accordance with the *Professional Syndicates Act*, "establish and administer pension plans to which the members or their employer may contribute" would be particularly interested in establishing an MFPP for its members.

As is the case for a traditional plan, establishment of an MFPP requires that the employer (or all the employers of a multi-employer plan) must acknowledge the obligations that are incumbent on the employer under the plan.

Furthermore, since the plan members assume the risk, specific measures are provided for obtaining their acknowledgment of the obligations that are incumbent on them.

Thus, for eligible workers[3] and active plan members represented by a union, the union must provide the pension committee with a declaration by which it acknowledges, on behalf of those it represents, the obligations incumbent on each of them under the plan.

For those not represented by a union, the pension committee must send them no later than 40 days before applying for registration of the plan, a notice indicating the main characteristics of an MFPP.[4] They will have 30 days following receipt of the notice to inform the pension committee in writing of their opposition to the obligations incumbent on them under the plan. The plan can be established if less than 30% of them send the committee a written notice of their opposition.

Each eligible worker and plan member must receive a summary of the plan indicating the main particulars of an MFPP:

- The plan is exempted from several provisions of the *Act*.
- The active members of the plan must pay the cost of the plan's commitments after subtracting from that amount the employer contribution.
- The benefits of members and beneficiaries under the plan can be indexed only if the plan remains fully funded and solvent.
- Surplus assets existing when the plan is terminated are allocated in their entirety to the plan's members and beneficiaries, pro rata to the value of their benefits.

1. Regulatory Impact Analysis Statement, *Regulations Amending the Income Tax Regulations (Omnibus Amendments–2007)*, published in the *Canada Gazette*, part II, 17 October 2007, electronic version: http://gazetteducanada.gc.ca/partII/2007/20071017/html/sor212-e.html. The *Regulations* add subsection 8510(9) to the *Income Tax Regulations*, setting particular conditions for MFPPs.

2. *Ibid.*

3. Eligible workers are workers belonging to the category of workers covered by the plan but who have not yet joined the plan.

4. For more detailed information, see section 75 of the *Regulation*.

3. Plan type

An MFPP is a defined benefit pension plan. It may be a multi-employer or a single-employer plan. It is a contributory plan, to which both the employer and the members contribute. This type of plan has limits:

- It cannot be an insured plan (all of whose refunds and pension benefits are at all times insured by an insurer);
- It cannot be a "designated plan" within the meaning of section 8515 of the federal *Income Tax Regulation*.[5]
- It cannot have, in addition to its defined benefit provisions, any defined contribution provisions. Thus, an MFPP can not be a *combination plan* or a *hybrid plan*.

Furthermore, to provide funding leeway:

- The plan cannot be an *average best earnings plan* or a *final pay plan*. It must therefore be a *career earnings plan* or a *dollar-per-month plan*;
- The plan cannot provide for automatic pension indexing, neither before nor during retirement. Also, it cannot offer members an indexed pension as an option. Indexation can be granted only on the basis of an amendment to the plan made in accordance with the rules indicated in section 8 of this document.

To avoid undue pressure and to ensure the full effectiveness of member protection mechanisms, the plan must always be only an MFPP. Thus:

- It cannot be created by the conversion of a traditional plan;
- It cannot be amended to become a traditional plan;
- Divisions and mergers can involve only other MFPPs;
- Since the provisions of an MFPP do not meet the requirements of the laws of other provinces, a worker in another province cannot be a member of an MFPP. The same is true for a worker whose rights are subject to the federal *Pension Benefits Act* (1985).

5. *Canada Gazette, loc. cit.*

4. Other plan characteristics

4.1 Sums paid by the members

In addition to regular member contributions, plan members may, if the plan allows, pay the following sums to the plan:

- Transfers. Such sums must be converted into a pension, based on the actuarial assumptions used to verify the plan's funding;
- Sums used to purchase current service or past service.
- Additional voluntary contributions. Such contributions must be placed until retirement in an account separate from all other contributions. They bear interest, and the account balance is paid to the plan member upon his or her departure, whether or not the plan is solvent. If the member retires, he or she is entitled to an additional pension based on the account, in the same manner as is the case in a traditional plan.

4.2 Pensions insured upon retirement

The plan provisions must indicate whether or not pensions will be insured by an insurer when retirement occurs.

If the pensions will not be insured, they must be indexed on the same basis as the pensions for non-retired members, and the valuation of the plan's funding must be made by assuming that they will be indexed.

If the pensions are insured by the plan, the retirees remain members, as in a traditional plan. The plan provisions must indicate whether or not their pensions will continue to be indexed after retirement. If indexation continues, the pensions must be indexed on the same basis as the pensions of the plan's non-retired members. The valuation of the plan's funding must be made by taking into account whether or not the plan provides for indexing pensions after retirement (see section 7.1 of this document).

5. Minimum benefits

The minimum benefits of a traditional plan apply also to an MFPP, with some exceptions:

- The **minimum employer contribution rule**, which requires the employer to fund at least 50% of the value of a member's pension, is incompatible with the MFPP, under which the employer's financial commitment is predetermined. Therefore, this rule does not apply to the MFPP.
- The **additional pension benefit rule** (see *Newsletter* number 16, December 2001) applies, with some adaptations, where a plan member applies for a refund or transfer of benefits or where he or she dies before retirement (see section 6 of this document). The rule does not apply where the plan member leaves his or her benefits in the plan. Instead, the rule is replaced by periodic indexing of the pension, based on the plans' financial situation (see section 7.2 of this document).
- Where a plan member applies for a refund of benefits or their transfer, or where he or she dies before retirement, the amount owing is adjusted, in particular to take into account the plan's degree of solvency.

6. Benefits adjustment following a departure or death

In an MFPP, the members collectively share any surplus assets and (in what should be an unusual situation) any assets deficiency. Where a member leaves the plan, his or her benefits must be determined such that he or she receives his or her share of any surplus assets or assumes his or her share of any assets deficiency. In this way, a departure does not change the plan's financial situation to the profit or detriment of the other members.

Thus, where a plan member applies for a refund or transfer of benefits or where he or she dies before retirement, the fact that the valuation on the basis of funding assumes full indexing of the pension must be taken into account. For that reason, **first the additional pension benefit rule, adapted to the MFPP, applies to the pension**. The value of the pension will therefore correspond to the higher of the following values:

- the value of the vested pension;
- the value of the partially indexed pension before retirement, as calculated for element "A" in the calculation of the additional pension benefit under a traditional plan pursuant to section 60.1 of the *Act*.

It must be noted that to calculate element "A", the value of the pension must be determined by assuming that payment begins at the normal retirement age. That value excludes early retirement advantages, bridge benefits and all other advantages provided for under the plan, in particular, optional forms of subsidized pensions for a spouse. Moreover, it must be assumed that the pension is indexed to 50% of changes in the consumer price index (CPI) expressed as an annualized rate that cannot be less than 0% or more than 2%, between the date of cessation of active plan membership and the date on which the member reaches the age that is 10 years before the normal retirement age.

Thus, the member will be entitled to the value of a partially indexed pension, unless his or her pension has early retirement advantages that are greater.

Second, the value of the pension is multiplied by the plan's degree of solvency, in order to add to it or subtract from it, as the case may be, the member's share of any surplus assets or assets deficiency. The degree of solvency to be applied is that which is the most recent on the date of the application for a refund or transfer of benefits or for payment of a death benefit.

To ensure that the degree of solvency applied corresponds as closely as possible to the plan's actual financial situation, it must be determined at the end of every fiscal year (or more frequently, if the plan so provides). For this purpose, the actuary must specify in his or her triennial valuation a method that will make it possible to summarily determine the degree of solvency at any time until the next triennial valuation, by taking into account the pension fund's rate of return and the change in the valuation rate.

In spite of the foregoing, a **minimum value test** must be made. No matter what the plan's degree of solvency may be, the amount paid to the member (or his or her successors) must be at least equal to the total of the following sums:

1. the sums transferred to the plan, with interest;
2. the sums paid by the member to purchase current service or past service, with interest;
3. the member contributions, with interest.

Therefore, although those sums are used to fund a member's pension, the plan must account for them separately (including the interest they bear), so that it will be possible to make the minimum value test.

The test is intended to avoid penalizing a member who participates in a plan "at the wrong time". For example, if a young member joins the plan when it is not fully solvent, makes contributions for one year and then leaves the plan while it is still not fully solvent, he or she will nevertheless receive at least the member contributions, with interest.

In addition to the sum required to pay a member's pension, the plan must remit to him or her any **additional voluntary contributions**, with interest. It must be noted that those sums bear interest and must be accounted for separately.

7. Funding

7.1 Valuation standards

Since the members of an MFPP assume the plan's financial risk, that risk must be limited as much as possible. Thus, an MFPP must be fully funded and solvent from its inception. Likewise, for an amendment to be made, the valuation must show that the plan will still be fully funded and solvent when the amendment takes effect, unless the amendment is required by a new statutory or regulatory provision that does not allow any latitude.

The valuation of an MFPP on the basis of funding must be made by assuming that the pensions are indexed to the CPI, to a maximum of 4%, although the plan text cannot provide for such indexation to be automatic (see section 3 of this document). This measure makes it possible to create an implicit margin equivalent to the cost of indexation. The valuation does not have to provide for the indexation of the pensions after retirement if the pensions are insured and if there is no indexation after retirement (see section 4 of this document).

7.2 Using assets

The *Regulation* governs the allocation of assets for paying the cost of plan improvements. First, it provides that the plan's assets must be enough for the plan to remain fully funded and solvent after taking the cost of an improvement into account. Second, it provides that pensions under the plan must first be indexed before other improvements may be made.

The indexation must be carried out uniformly for all the active and non-active members, including retirees and beneficiaries. It must apply to every period to which such indexation has not already been carried out. However, the indexation will not apply to the pensions of retired members where the plan provides that such pensions are insured and are not indexed after retirement.

The indexation must take effect, at the earliest, as at the valuation date, but no later than one year after that date. It must be limited to a level that can be funded by the assets while keeping the plan fully funded and solvent.

If there are sufficient assets after the indexation, they can be used either to change the member or employer contributions or to increase pension benefits, so long as the plan remains fully funded and solvent.

7.3 Changing the employer contribution

The employer contribution cannot be increased or reduced unless an amendment is made to the plan, under the conditions explained in section 8 of this document. Those conditions require the employer's acknowledgment of any change.

The rules for employer contribution holidays that apply to a traditional plan do not apply to an MFPP. In an MFPP, excess assets can be appropriated to the payment of employer contributions only if necessary to comply with taxation rules.[6]

7.4 Changing the member contribution

In an MFPP, the active members must assume the obligations that are assumed in a traditional plan by the employer. Thus, the member contributions must be at least equal to the account balance of the plan's cost.

If an actuarial valuation shows that the member contributions were **lower** than they should have been since the previous valuation date, the amount lacking, with interest, can be distributed uniformly over the period remaining until the date of the next actuarial valuation. If that valuation shows the current service contributions were **higher** than they should have been, they can likewise be adjusted.

Moreover, the active members must pay the amounts required to amortize any deficits. If a valuation shows a deficit, the member contributions must be increased, as of the valuation date, to amortize them. However, the person or body who has the power to amend the plan can decide that the contribution adjustment required to cover amortization, with interest, will begin, at the latest, 12 months after the valuation date and will be spread over the remainder of the 5-year period that began on the valuation date.

For example, the valuation as at 1 January 2010, submitted on 1 June 2010, shows a solvency **deficit**. That deficit could be amortized by a series of payments from 1 January 2011 to 1 January 2015, instead of from 1 January 2010 to 1 January 2015. However, those payments will have to take into account interest on the amounts that otherwise would have been paid in 2010. Likewise, if the unfunded actuarial liability is in the 15-year amortization category (until 2025), only the payments for the first 5 years can be spread over a shorter, 4-year, period, as indicated above.

Where a valuation shows that there are **surplus assets**, on the basis of both solvency and funding, and subsequent to the indexation provided for in the *Regulation*, a contribution holiday can be taken for as long as the surplus persists.

The pension committee must inform all active members of any change in the member contribution and provide them with a written notice that specifies the effective date of the change as well as the new contribution or the method for calculating it. The notice must be provided no later than 30 days after the date on which collection of the new contribution begins.

6. *Canada Gazette, loc. cit.*

8. Amendments to the plan

Like a traditional plan, the text of an MFPP must indicate who can amend the plan and under what conditions. However, the employer (or the group of employers) cannot be given the right to unilaterally amend an MFPP, either directly or indirectly, since the employer does not assume the risks. It could be provided, for example, that amendments are decided by the union or negotiated between the union and the employer.

Increases in pension benefits must be kept within the limits allowed under the funding rules that are specific to an MFPP. Therefore, so long as the indexation of the pensions accrued up to the date of the most recent actuarial valuation has not been provided for in the plan, no other improvement can be granted, even if the cost of the improvement is paid in a single payment or entirely by an increase in current service contributions. (For indexation details, see section 7.2 of this document.) It would not be allowed, for example, to increase pensions from 1,2% of the salary to 1,4% of the salary for each year of service, for service credited since the coming into force of the amendment unless the pensions accrued up to the most recent actuarial valuation have first been indexed at the required rate.

Reducing amendments in an MFPP, like those in a traditional plan, are subject to section 20 of the *Act* as it relates to their effective date.

As in a traditional plan, the notice prior to registration of any amendment must be sent to the active and non-active plan members, pursuant to section 26 of the *Act*. The notice may instead, subject to the provisions of that section, be posted or published in a newspaper. However, where an amendment is made under the provisions of a collective agreement, that section does not require that a notice be sent of the active members covered by the collective agreement.

For every amendment concerning the obligations incumbent on the employer, whether they are increased or reduced, the employer must acknowledge the amended obligations, unless the amendment:

- is made mandatory by a new legislative or regulatory provision giving no latitude;
- is made to withdraw an employer because of the employer's bankruptcy or insolvency.

In an MFPP, the employer's obligations are not affected by an increase or reduction of pension benefits. However, they are affected where the employer contribution is changed.

In addition, where an amendment affects the obligations of the **unionized active members**, whether they are increased or reduced, the union must provide the pension committee with a declaration by which it acknowledges, on their behalf, the obligations incumbent on them as a result of the amendment. That declaration is not required, however, where the amendment:

- is made mandatory by a new legislative or regulatory provision giving no latitude;
- is made to withdraw an employer because of the employer's bankruptcy or insolvency;
- is made to withdraw a group of members who have ceased being workers eligible for plan membership;

In the case of amendments aimed at increasing the plan's commitments, including commitments that increase pension benefits, the acknowledgment of the **active plan members who are not represented by a union** must also be sought.

To obtain that acknowledgment, the pension committee must send them a notice at least 40 days before applying for registration of the amendment. The notice, which may be combined with the notice that must be sent to them pursuant to section 26 of the *Act*, must include the purpose of the proposed amendment and its effective date. It must also specify that they have 30 days as of receipt of the notice to make known to the pension committee their opposition, if any, to the amendment.[7] If less than 30% of those members express opposition to the amendment, they are deemed to have given their acknowledgment.

Amendments that do not require an acknowledgment by the union do not require an acknowledgment by the non-unionized plan members.

7. For details on the contents of the notice, see section 75 of the *Regulation*.

9. Departure of a group of members

Where a group of plan members cease to be eligible for plan membership, for example, because they have changed their union affiliation, their departure is handled like the withdrawal of an employer, by adapting the provisions of the *Act* as required to maintain equity between the remaining groups and to avoid potential conflicts.

However, if the departing members become eligible for membership in another MFPP, their departure is handled like a division/merger, that is, a division of the part of the plan related to that group in order to merge it into the new plan. The person or body with the power to amend the plan makes the requisite amendments. Otherwise, the pension committee must make them on its own initiative.

It must be noted that the acknowledgment of the employer, the union and the active members who are not represented by a union is not necessary for this category of amendments.

10. Withdrawal of an employer

In order for an employer to withdraw from an MFPP, the plan must be amended by the person or body with the power to make the amendment. The plan must provide for a rule that determines the effective date of such an amendment. The date cannot be later than the end of the fiscal year that follows the one in which the last contribution must be made for the plan members associated with the employer. Unlike a traditional plan, no specific rule is provided with respect to the withdrawal date in the case of an employer who goes bankrupt.

The time allowed before the amendment takes effect makes it possible for some members, who otherwise would be affected by the withdrawal, to begin working for another employer party to the plan and to thus be able to continue their active plan membership, if under the plan provisions, active membership does not end as of the end of the period of continuous service, as allowed under the last paragraph of section 36 of the *Act*.

For the members and beneficiaries affected by the withdrawal of their employer, the effects can be compared with those of a plan termination. Their benefits must be paid in the same manner as if there was termination (transfers for non-retired members and purchase of an annuity for the retirees), and they then cease to be plan members or beneficiaries.

If the plan has surplus assets, the affected members and beneficiaries will receive their share. If the plan has a deficit, the employer is not required to make up for the lack of assets. However, the employer must pay the employer contributions due up to the effective date of the employer's withdrawal. The members' benefits will be reduced to take the deficit into account, in the same manner as in the case of a plan termination.

11. Plan termination

In a traditional plan, the employer has the right to end the plan. A plan can be terminated at any time, unless a collective agreement prevents the employer from terminating the plan during a certain period, for example, for the duration of the collective agreement. It is not the same with a MFPP. The employer cannot unilaterally terminate the plan, directly or indirectly. The plan text must indicate who has the power to terminate the plan and under what conditions. The plan text could, for example, give this power to the union, with or without the employer's consent.

The termination procedure for an MFPP is the same as for a traditional plan, except for the allocation of surplus assets or of a debt. However, adaptations are necessary. For example, the termination notice must also be sent to the employer.

If the plan has surplus assets, they are automatically allocated to all the members and beneficiaries, pro rata to the value of their benefits. If the plan has a deficit, the employer is not required to make up for the lacking assets. The employer is required only to pay the employer contributions due up to the effective date of the termination. The members' benefits will be reduced to take the deficit into account.

12. Partition, seizure and early pensions

12.1 Calculation of the value of benefits

Where the pension committee must calculate the value of benefits for the purpose of **partition** or in the event of a **seizure**, the *Regulation* requires a calculation of the member's vested benefits. If the member has not become entitled to a pension, which is usually the case for an active member, the value of the deferred pension to which he or she would be entitled if active membership ceased must be calculated.

In a traditional plan, it is not assumed that the member applies for a transfer of his or her benefits. However, in an MFPP, the value of the pension must be multiplied by the plan's degree of solvency as at the valuation date, as the case may be, either the date of introduction of the action, of the date on which cohabitation ended or the date of the seizure.

12.2 Payment to the spouse

In a traditional plan, where the plan is not solvent, the sum due to the conjoint following **partition** must be paid pro rata to the plan's degree of solvency, and the balance must be paid to the pension fund by the employer, to be remitted to the spouse no later than 5 years thereafter. In an MFPP, since plan solvency has already been taken into account in calculating the value of benefits, this rule does not apply. The entire sum due to the spouse must be remitted to him or her regardless of the plan's degree of solvency.

On the other hand, since pension benefits are involved, the sum to be remitted to the spouse bears interest at the rate of return obtained on the investment of the plan's assets, less investment and administration fees, rather than at the rate used to establish the value of the benefits.

12.3 Calculation of a negative pension

Unlike the negative pension determined in a traditional plan, which is adjusted only at retirement to take into account an early or a postponed pension, the negative pension determined in an MFPP following **partition**, a **seizure** or an **early pension** must be indexed in the same manner as the normal pension of the plan's members and beneficiaries.

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