PENSION PLAN TAXATION IN CANADA: PROMOTING A SUSTAINABLE RETIREMENT FUTURE BY REDUCING THE TAX BURDEN OF RETIREES

Hennadiy Kutsenko*

CONTENTS

1. Introduction

When the dust settled and the Supreme Court of Canada finally concluded the hard-fought battle for creditor priority between the pension plan members and the U.S. parent company of the Canadian steel manufacturer in *Sun Indalex*

* This article was written as a Major Research Paper for the Professional LLM Program in Tax Law, Osgoode Hall Law School, York University, Toronto.

Finance,[1] the pensioner's loss was just an example of a much broader struggle. This high profile Supreme Court of Canada case dealt with the catastrophic effects of underfunded defined benefit pension plans on companies already embroiled in financial struggles. The Supreme Court of Canada decided that the federal insolvency legislation took paramountcy over the provincial deemed trust legislation that would have given the pension plan members priority in the amount of the wind-up deficiency that the employer was required to pay to top up the underfunded defined benefit plan.[2] No constructive trust was found in respect of this amount either, as there was no identifiable asset found to be created in the *CCAA* proceedings.[3]

However, the majority of the Supreme Court of Canada nevertheless found that the future amounts required to be paid to fund the wind-up deficiency of the pension plan were subject to a statutory deemed trust.[4] This meant, effectively, that while provincial legislation grants considerable security to pension benefits in liquidation scenarios, insolvency or bankruptcy proceedings will mean that federal paramountcy will restrict recovery to funding already present before the federal insolvency or bankruptcy proceedings began.[5]

While dealing with a set of very specific issues, *Indalex* highlighted an ongoing and concerning trend. This was not the only recent case where underfunded defined benefit pension liabilities have played a considerable role in company insolvency proceedings, tense creditor priority battles with other creditors included — Nortel Networks and, more recently, U.S. Steel immediately come to mind.[6] One might go even further and declare that the conflict continues for pension retirees and pension plans in general, which are slowly but surely fading away.[7]

1. *Re Indalex Ltd.; Sun Indalex Finance LLC v. United Steelworkers*, 2013 SCC 6 (S.C.C.).
2. *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36; s. 57(4) of the *Pension Benefits Act*, R.S.O. 1990, c. P.8; and s. 30(7) of the *Personal Property Security Act*, R.S.O. 1990, c. P.10, respectively.
3. *Indalex*, *supra*, footnote 1, at para. 227.
4. *Indalex*, *supra*, footnote 1, at paras. 45 and 26.
5. Ronald B. Davis, "Security of Retirement Benefits in Canada: You Bet Your Life" (2013), 17 Can. Lab. & Emp. L.J. 65, at p. 94.
6. See for example *Re Nortel Networks Corp.*, 2009 CarswellOnt 3583 (Ont. S.C.J. [Commercial List]), affirmed 2009 CarswellOnt 7383 (Ont. C.A.), leave to appeal refused 2010 CarswellOnt 1760 (S.C.C.); and *Re U.S. Steel Canada Inc.*, 2016 ONSC 569 (Ont. S.C.J.), additional reasons 2016 CarswellOnt 9884 (Ont. S.C.J.).

This is particularly true for the defined benefit pension plan, where a plunge in interest rates, poor market performance, increasing longevity and overly generous discount rates have led to considerable underfunding.[8] More and more, employers are engaging in de-risking measures that seek to reduce the considerable liabilities that defined benefit pension plan obligations entail. These de-risking measures include making the change to defined contribution plans, which offer retirees much less security and certainty on retirement.[9] Shifting the pension plan liability onto insurers in the form of annuities is also becoming more and more popular, where plan sponsors seek to reduce their longevity, market and interest rate risk through purchasing buy-in or buy-out annuities.

Numerous initiatives have been led by federal and provincial governments to save failing pension plans and promote a more sustainable retirement future. These initiatives have included revising provincial solvency funding rules to alleviate the pressure on defined benefit plan sponsors,[10] adopting alternative pension plan models such as target benefit plans[11] and pooled registered pension plans,[12] expanding the public pension plan system[13] and relieving certain pension plan sponsors of particular liabilities.[14] Undoubtedly, there has been a great deal of attention given to the topic of survival of the pension plan and the overall sustainability of the retirement system.

However, there has been less discussion devoted to the tax treatment of pension plans and the tax burden on retirees, despite considerable attention having been paid to how taxing

---

7. Jim Leech and Jacquie McNish, "The Third Rail: Confronting Our Pension Failures" (Toronto: McLelland & Stewart, 2013), at p. 24.
8. *Ibid.*
9. *Ibid.*
10. See for example, *General*, O. Reg. 250/18, filed April 20, 2018 under the Ontario *Pension Benefits Act*.
11. National Pension and Benefits Law Section, Canadian Bar Association, "Pension Innovation in Canada: The Target Benefit Plan" (Ottawa: The Association, June 2014).
12. See the *Pooled Registered Pension Plans Act*, S.C. 2012, c. 16.
13. See the Canada Pension Plan Enhancements in *Bill C-26: An Act to amend the Canada Pension Plan*, *the Canada Pension Plan Investment Board Act and the Income Tax Act*, adopted by the House on November 30, 2016. These measures are now in force.
14. See, for example, *U.S. Steel Canada Pension Plans*, O. Reg. 255/17, filed June 30, 2017; and *General Motors Pension Plans*, O. Reg. 321/09, under the Ontario *Pension Benefits Act*.

employment income impacts personal behaviour.[15] To that end, while there is some writing out there on the policy behind the tax treatment of registered pension plans and other retirement savings vehicles, it has rarely been considered whether changes in the *Income Tax Act* (the "ITA")[16] can contribute to pension plan survival as a specific effort against the current trend of diminishing pension plan sustainability.

Accordingly, in this paper, I consider the income tax treatment of registered pension plans as a means of improving and reinforcing sustainability of the Canadian retirement system. I explore whether the current regime under the ITA is equitable to retirees who bear the ultimate tax burden of the pension payout and consider whether some of the tax burden ought to be alleviated or shifted. Doing the latter may contribute to the sustainability of pension plans through allowing a lower pension promise for employers, potential lower contribution levels by employer and employee alike, or at the least, a lesser tax burden in the retirement years (which are arguably subject to extremely high effective tax rates).[17]

The specific issue I explore is the inability of a pension plan to take advantage of beneficial tax treatment given to certain types of income, due to being a tax-exempt entity under Division H of the ITA.[18] What follows is the inability of retirees to receive the benefit of that tax treatment when they bear the ultimate tax burden when they receive their pension payout upon retirement.

The issue can be demonstrated in a very simplified example. Suppose a pension plan earns 50% of its returns on dispositions of property on capital account and 50% on interest income. Were the plan fully taxable as a regular investment vehicle, given the 50% inclusion rate for capital gains, the plan would effectively only pay tax on 75% of its earnings. However, the capital gains treatment is lost through the pension plan's tax-exempt status and the beneficiaries of the plan pay tax based on a 100% inclusion rate when they receive their pension benefits after retirement (instead of the 75% inclusion rate, if the plan

15. Alexandre Laurin and Finn Poschmann, "Who Loses Most? The Impact of Taxes and Transfers on Retirement Incomes" (Toronto: C.D. Howe Institute, November 13, 2014), at p. 1.
16. R.S.C. 1985, c. 1 (5th Supp.). All legislative references in this paper are to the *Income Tax Act*, unless specified otherwise.
17. Laurin and Poschmann, *supra*, footnote 15, at p. 2.
18. ITA, paras. 149(1)(o)-(o.2) exempt pension trusts and corporations from tax.

was able to flow the income through and let it retain its character as capital gains in the hands of the retirees).

In a similar vein, pension plans cannot flow-through the benefit of the gross-up and tax credit treatment for dividends to the individual plan members[19] and there is currently no ability to use or flow-through the lifetime capital gains deduction.[20] Ergo, retirees who receive the pension income after retirement are also unable to take advantage of the tax treatment given to these types of income. If they were able to do so, their tax burden might be reduced alongside with the funding burden of the plan sponsor, as suggested above.

I consider the above issue in detail. I begin by outlining the history of pension plans in Canada. Next, I briefly discuss the policy behind taxation of registered pension plans and describe the technical elements of the Canadian tax treatment of pensions and pension plans in detail. Following this, I describe the main issue in detail and continue on to explore potential means of accounting for the inability to retain the character of capital gains and dividend income and how this measure could be implemented, juxtaposing the possible solutions against the current legislative landscape.

After the above, I consider the counterarguments to this thesis. The first of these is the practical concern of the administrative complexity in implementing the various measures that could be taken and whether the costs could be prohibitive. Second, the question of whether an economic benefit is even attained is addressed; given the already considerable benefit that arises from tax deferral alone, it may just be the case that the current system actually provides a higher tax benefit than the proposed changes would. Lastly, I consider the policy concerns that arise due to providing an already privileged cohort (*i.e.,* those that have access to a pension plan) with further benefits.

The purpose of this paper is an exploratory one that seeks to introduce an issue for discussion (rather than offer a clear resolution) and this topic needs to be studied and explored further as a potential means of assisting the sustainability of pension plans and thereby promoting a better Canadian retirement system. This paper is necessarily limited in its scope and breadth and focuses on defined benefit pension plans (for the most part). While, as mentioned above, the technical ITA

19. Sections 82 and 121 of the ITA.
20. Section 110.6 of the ITA.

rules relating to pension plans and the means to possibly account for beneficial tax attributes will be considered in detail, this paper does not consider the highly technical nuances of certain types of pension plans (such as specified multi-employer pension plans or individual pension plans) or GST and HST issues. Finally, this paper does not present formulaic actuarial or economic analysis, opting instead for a conceptual approach.

2. The History of Pensions and Pension Plans in Canada

Canada has an extensive and eventful pension history. It paints a colourful picture of labour movement struggles, investment faux-pas and a perfect storm that has threatened the future of defined benefit pension plans like nothing before. Any analysis of potential tax measures that seeks to address problems currently faced by pension plans and retirees must be situated in this broader historical context.

Canada has been called a pioneer in the world of pensions and pension plans,[21] being one of the first countries in the world to introduce pensions into the employment compensation formula. This began in the middle of the 19th century where Loyalist soldiers that fled to the Maritimes after the American Revolution received one of North America's first pensions in the early 1800s.[22] However, when New Brunswick's pension legislation was introduced in 1839, the benefits were minuscule and were intended more as a charity rather than deferred employment compensation.[23] The process to apply for a pension was humiliating and success was rare.[24]

Subsequently, in the last quarter of the 19th century when manufacturing employment doubled in size, the workers who had previously toiled in the farm fields and their respective various trades could no longer rely on their offspring to provide the means of support in their retirement when the family business was taken over.[25] Accordingly, they had to seek other means and measures to provide for retirement. These other means were provided in the form of pension plans, beginning in

21. Leech and McNish, *supra*, footnote 7, at p. 8.
22. *Ibid.*
23. *Ibid.*, at p. 9.
24. *Ibid.*
25. National Union of Public and General Employees, "Pensions Backgrounder #2: A Brief History of Pensions in Canada", *National Union's Pensions Manual*, 4th ed. (Nepean, Ontario: The Union, March 2007).

the railroad industry. The Grant Trunk Railway founded North America's first large-scale industrial pension plan in 1874.[26] By the 1900s, most railway workers had pension plans. Banks and insurance companies had also been developing new financial instruments for saving for retirement[27] and began introducing pension plans as a workplace perk, with Bank of Montreal leading the way in 1885.[28]

Early pension plans, however, did not have the legislative protections, sophisticated investment strategies and actuarial understanding of the plans of today.[29] They were financed on a pay-as-you-go basis out of the sponsoring employers' operating expenses,[30] with no reserves with which to counteract economic shocks.[31] The latter were simply not necessary; the average life expectancy in 1874 was 55 and retirement age under the pension plans was 70 — most workers would never collect their pension and therefore, most employers would never have to actually payout their pension liability.[32]

Ironically, pension plans were also used to control workers — a tool for encouraging loyalty and patronage by employees.[33] Employers could decide on a whim whether to withdraw pension benefits, such as when workers joined legal strikes, committed a felony or were perceived disloyal in anyway.[34] The eligibility periods to join the workplace pension plan were usually a decade,[35] and employers had immense discretion as to the amounts paid. Given that most workers also could not afford to purchase the government annuities under the *Canadian Government Annuities Act of 1908*, Canada's first retirement savings legislation,[36] financial stability in retirement was not particularly promising.

---

26. Leech and McNish, *supra*, footnote 7, at p. 8.
27. "Pensions Backgrounder #2", *supra*, footnote 25, at p. 1.
28. *Ibid.*, at page 11.
29. *Ibid.*, at p. 2.
30. Leech and McNish, *supra*, footnote 7, at p. 12.
31. "Pensions Backgrounder #2", *supra*, footnote 25, at p. 2.
32. Leech and McNish, *supra*, footnote 7, at p. 11.
33. Isla Carmichael, "The Development of Unions and Workplace Pension Plans", *Pension Power: Unions, Pension Funds, and Social Investment in Canada* (Toronto: University of Toronto Press, 2005), pp. 13-22.
34. Leech and McNish, *supra*, footnote 7, at p. 11 — both Grand Trunk Railway and Canadian Pacific Railway pulled pensions when workers joined legal strikes in the early 1900s.
35. *Ibid.*
36. "Pensions Backgrounder #2", *supra*, footnote 25, at p. 2.

Things changed with the onset of the Great Depression, which tumbled the financial markets. Interestingly enough, mortality rates declined and workers were now living longer, forcing many companies to reconsider the terms of their pension plans — it seemed as if companies would have to actually pay out the pensions.[37] The cost was substantial,[38] as was evidenced by the failure of the Morris Packing Company pension plan in 1923.[39]

The resistance to reform was substantial. Companies did not want the funds with an independent fiduciary and vesting rights were not in line with the view that pensions were a reward for long-term employees.[40] However, unionization and collective bargaining now characterized the environment, with the United Automobile Workers Union successfully bargaining the first collective agreement to include a defined benefit pension plan with General Motors in 1950.[41] By the 1970s, most federal, provincial and municipal employees also had pension plans, alongside automotive industry and railway workers.[42]

By the 1980s, pension plans had also become key players in Canadian capital markets. In 1980, pension fund assets in Canada were $65.5 billion, having grown from $4.8 billion in 1960. Their growth exceeded that of any other financial institution. By 1985, they had outstripped most other financial institutions to become second only to the chartered banks in Canada.[43] And while pension plans had previously been severely curtailed in their investment mandates, generally being restricted to investing in government bonds and debentures, the 1990s brought on pressure by pension advocates to allow plans to diversify their investments.[44] Major plans, such as the Canada Pension Plan ("CPP"), and Ontario Teachers' Pension Plan ("Teachers" or "OTPP"), took advantage of the success of reforms in this respect, quadrupling their assets by 2013.[45]

In the 1990s, defined benefit pension plans were doing well. So well, in fact, that the major issue of the day was entitlement to the fund surplus, with the majority of pension litigation

37. Leech and McNish, *supra*, footnote 7, at p. 12.
38. *Ibid.*
39. "Pensions Backgrounder #2", *supra*, footnote 25, at p. 2.
40. *Ibid.*
41. Leech and McNish, *supra*, footnote 7, at p. 12.
42. *Ibid.*, at p. 14.
43. Carmichael, *supra*, footnote 33.
44. Leech and McNish, *supra*, footnote 7, at p. 16.
45. *Ibid.*, at p. 16.

concerning surplus entitlement and employer contribution holidays.[46] But this was short-lived. Throughout the 2000s, a conglomeration of events and economic factors sent the pension landscape toppling. Interest and mortality rates both dropped substantially, with the result that plans were earning less but having to pay out pensions for much longer periods than anticipated.[47] The baby boom generation workers began retiring. The dot.com crash in 2002 and financial crisis in 2008 sent pension assets further downwards as pension plans had been exposed to the volatility of riskier market investments, having turned to the stock market due to plummeting rates of return on traditional fixed interest investments.[48] The timing couldn't have been poorer (or more perfect) for pension plans.

The impact of this was tremendous. Severely underfunded plans began to pull companies into insolvency. Employers began to freeze defined pension benefit plan membership, offering defined contribution plan membership (if any) instead and shareholders grew more and more wary of pensions, now seeing them as a liability rather than a workplace perk to attract talent.[49] Private sector defined benefit pension plan membership dwindled down to 12% in 2013, from 35% in the 1970s.[50] While 80% of public sector employees still belong to defined benefit pension plans,[51] these large pension entities are hardly representative of the average Canadian defined benefit pension plan, with the future becoming more and more bleak for these types of plans in the private sector.

Accordingly, the current status of the Canadian pension plan, defined benefit plans in particular, is very uncertain and appears to be headed the way of the dodo. With your market standard share purchase agreement language including a representation that the seller does not currently sponsor a pension plan and is not aware of any negotiations or proposals for such a pension plan, it seems that the third pillar of the Canadian retirement savings regime (the first two pillars being government funded

46. Murray Campbell and Craig Ferris, "How Class Action Suits are Changing the Pension and Benefits Landscape" (Victoria, B.C.: Lawson Lundell LLP, November 10, 2004), at p. 6.
47. Leech and McNish, *supra*, footnote 7, at p. 16.
48. *Ibid.*, at p. 17.
49. *Ibid.*, at p. 144.
50. *Ibid.*, at p. 144.
51. Malcolm Hamilton and Philip Cross, "Risk and Reward in Public Sector Pension Plans: A Taxpayer's Perspective" (Vancouver: Fraser Institute, 2018).

old age supplements and compulsory workplace pension plans such as the Canada Pension Plan ("CPP") and Quebec Pension Plan ("QPP"), respectively) is wearing thinner by the moment, leaving a shaky retirement roof for Canadians.

3. Taxation of Pension Plans

The current taxation of Canadian pension plans is built on principles of equity and arises from pension taxation reform discussions that took place in the mid-1980s. These discussions culminated in the introduction of a comprehensive regime that sought to equalize access to tax-deferred retirement savings plans between those who have access to workplace pension plans and those who do not (thereby having to rely on voluntary savings plans, such as RRSPs). In this paper, I briefly discuss some broader principles of the tax policy behind pension plan taxation and then consider the technical rules of the Canadian pension plan taxation regime in detail.

3.1 Retirement Savings Tax Policy

Much has been written on the policy behind the tax treatment given to pension plans and other retirement savings vehicles, from discussions on risk-taking neutrality[52] and optimal investment asset allocation[53] to the various models of pension plan taxation and to what extent each such model represents either income or consumption taxation (or a measure of both).[54] A primary element consistent throughout is that consumption taxation is a persistent factor in the policy behind taxing retirement savings across the globe.[55] A consumption tax is generally imposed only on the portion of income that is used to make purchases (*i.e.,* consumed) and not income put away in savings, unlike an income tax that taxes all income regardless. A consumption taxation system is arguably simpler for pension plans, as it avoids the measurement problems of an income tax

52. Katarzyna Romaniuk, "Pension Fund Taxation and Risk Taking: Should We Switch from the EET to the TEE Regime?" (November 2013), 9 Annals Fin. 573.
53. J.B. Shoven and C. Sialm, "Asset location in tax-deferred and conventional savings accounts" (2003), 88 J. Pub. Econ. 23.
54. Jonathan Barry Forman, "The Tax Treatment of Public and Private Pension Plans around the World" (Fall 1997), 14 Am. J. Tax Policy 299.
55. *Ibid.*

system that relate to taxation of investments (as described below).[56] It is also arguably fairer as it does not tax the same amounts twice[57] and also promotes savings and therefore investment and economic growth.[58]

Most countries use the "EET" system of taxing pension plans — exempt, exempt, taxable.[59] In other words, the contributions to a pension plan are exempt from taxation (the first "E"), the earnings during the investment or accumulation stage are similarly exempt (the second "E") and the payout in the decumulation state *i.e.,* upon retirement, is usually taxable (the "T"). The EET model is primarily based on a consumption taxation approach, as is the TEE model (*i.e.,* no deduction on the contribution, but exempt on payout).[60] ETT and TTE systems represent an income tax approach and ETE and TET could be either, depending on how the tax is calculated and imposed.

One issue with the income tax approach, *i.e.,* ETT and TTE, is the measurement and allocation of investment income to individual members based on the earnings of the plan for the purpose of imposing tax under the second element, *i.e.,* the middle "T". This is difficult to do practically speaking and the better choice is to approximate the benefit accrual to each individual member.[61] In light of this and the other benefits of a consumption taxation model discussed above, income taxation models of pension plans are relatively rare and most countries favour the EET or TEE approach accordingly, depending on the type of retirement savings vehicle.

In line with the majority of countries, Canada's taxation system of pension plans also follows the EET model and, accordingly, a consumption taxation system is favoured here over an income taxation model.

3.2 The Technical Provisions

Prior to 1990, the majority of the technical rules governing pension plans were not contained in the ITA but rather CRA administrative policy. CRA Information Circular 72-13R

56. Forman, *supra*, footnote 54, at pp. 321-322.
57. Heather Kerr, Ken McKenzie, and Jack Mintz, "Tax Policy in Canada" (Toronto: Canadian Tax Foundation, 2012), at p. 4:5.
58. Forman, *supra*, footnote 54, at pp. 321-322.
59. Romaniuk, *supra*, footnote 52.
60. Forman, *supra*, footnote 54, at p. 325.
61. *Ibid.*, at p. 318.

prescribed rules regarding pension plan registration eligibility, including rules concerning current and past service contributions, use of actuarial surplus and numerous other components of an employee pension plan that were necessary for registration. Generally applicable starting in 1990, the rules were incorporated into a larger regime in the ITA, contained in sections 147.1 to 147.3 and Parts LXXXIII to LXXXV of the ITA regulations[62] (the "*Regulations*"). Certain other key provisions throughout the ITA support the regime for registered pension plans outlined in these sections, particularly the rules concerning the exemption from Part I tax in paras. 149(1)(o) - (o.4) of Division H in Part I.

The point of departure for the treatment of pension plans and their beneficiaries in the ITA is the definitions in subsec. 147.1(1), where certain key terms are outlined. The first component of the Canadian EET regime, *i.e.,* the actual income that forms the contribution (and is subject to a deduction against income tax) to the pension plan is covered in the definition of "compensation". "Compensation" includes income from employment or office under sections 5 and 6 of the ITA, effectively excluding severance payments in the form of retiring allowances, which are taxed under s. 56. This would also appear to exclude stock option plan benefits under s. 7 of the ITA, although the CRA disagrees.[63]

Subsection 147.1(1) defines the "money purchase provision" of a pension plan as terms of the plan that provide for a separate account maintained in respect of each member, whereby contributions are credited to that account and the benefits are determined solely by reference to the amounts therein. Therefore, money purchase provisions are effectively defined contribution components of pension plans. Conversely, a "defined benefit provision" is any term of a plan under which the benefits are determined other than by "money purchase provision" means, therefore referring to defined benefit portions of a pension plan.

A "money purchase limit" is provided in subsec. 147.1(1), which is the annual contribution limit for defined contribution pension plans and is effectively the maximum by which RRSP room can be reduced for defined contribution plans. The amount is indexed to inflation and is $27,230 for the year

62. *Income Tax Regulations*, C.R.C. 1978, c. 945.
63. CCRA RPP 2002 Consultation Session, question 2.

2019. The equivalent contribution limit for defined benefit plans is the "defined benefit limit", defined in subsec. 8500(1) of the *Regulations* to be the greater of $1,722.22 and 1/9 of the "money purchase limit", effectively $3,025.56 for 2019. These are both discussed in further detail below.

Pension Plan Registration

Subsection 147.1(2) provides that the Minister may register a pension plan if an application is made in prescribed manner, the plan complies with prescribed conditions and application under federal or provincial pension and benefits legislation has been made (if required). Amendments to plan conditions are acceptable only if certain conditions are met as well. The prescribed conditions for registration are contained in paras. 8502(a), (c) (e) (f) and (l) of the *Regulations*. They are as follows:

- the plan's primary purpose must be to provide periodic payments to individuals after retirement and until death in respect of their employment service;[64]
- The benefits provided under a money purchase provision of a pension plan can only be lifetime retirement benefits, bridging benefits and survivor benefits, among certain others.[65]
- The permissible benefits under a defined benefit provision include the lifetime retirement benefits, bridging benefits and survivor benefits as well as certain lump sum payments, among certain others.[66]
- The maximum lifetime retirement benefits provided under defined benefit plans are limited to the lesser of:[67] (a) 2% of the member's "highest average compensation"[68] multiplied by the number of years of "pensionable service",[69] and (b) the "defined benefit limit" (as discussed above) multiplied by the number of years of pensionable service;[70]

64. *Regulations*, para. 8502(a).
65. *Regulations*, subsecs. 8506(1).
66. *Regulations*, subsecs. 8503(2) and (3).
67. *Regulations*, subsec. 8504(1).
68. As calculated under the *Regulations*, subsec. 8504(2).
69. Defined in the *Regulations*, subsec. 8500(1), compared to the 35-year ceiling in IC 72-13R8.
70. Compared to the $1,715 per year maximum in IC 72-13R8.

- The plan must require that the retirement benefits of a member begin to be paid not later than the end of the calendar year in which the member reaches 71, and such benefits must be payable at least annually;[71]
- Under the plan terms, no right of a person under the plan can be capable of being assigned, surrendered, charged, anticipated or given as security[72] (with certain exceptions), and;
- The plan terms must be such that pension amounts determined under Part LXXXIII are appropriate "having regard to the provisions of that Part read as a whole and the purposes for which the amount is determined".[73]

Once an application for registration has been properly submitted, the plan is deemed to be registered at the later of the date it commences or January 1 of the calendar year in which the application is made, ending on the day that final determination is made, pursuant to subsec. 147.1(3).

Deductibility of Contributions

Contributions to a registered pension plan are deductible for both employer and employee (if applicable). Subsection 147.2(1) provides that employer contributions to a registered pension plan are deductible if certain criteria are met, namely that money purchase plan contributions must be made in accordance with the plan as registered and defined benefit contributions must be "eligible contributions"(meaning contributions that are made on the recommendation of an actuary, are based on an actuarial valuation that complies with certain prescribed conditions and is approved by the Minister in writing,[74] among certain other prescribed conditions).[75]

Employee contributions for post-1989 service (whether current or past-service, as discussed in further detail below) are also deductible when made to a registered pension plan. Contributions towards unfunded liabilities are deductible as well, provided they are determined by reference to the actuarial

71. *Regulations*, subsec. 8502(e).
72. *Regulations*, subsec. 8502(f). Note that similar requirements are imposed by pension and benefits statues.
73. *Regulations*, subsec. 8502(l).
74. ITA, subsec. 147.2(2).
75. *Regulations*, subsec. 8516(2) and (3).

liabilities under the plan, cannot reasonably be considered to be in respect of the member's benefits, and are made pursuant to an arrangement approved by the Minister where the main purpose of the arrangement is to ensure that the plan is adequately funded.[76] Pre-1990 contributions may also be deducted to a certain limit and subject to certain conditions.[77]

Employer contribution deductions are limited by para. 20(1)(q), which provides that only contributions made in accordance with subsec. 147.2(1) or (10) may be deducted. This limitation does not include administrative costs, which may be deducted under general principles under s. 9 in the ITA. Pursuant to para. 8(1)(m), employees are also limited in deducting their pension contributions and must do so in accordance with s. 147.2(4). Employees do not receive a taxable employee benefit when an employer makes a contribution on their behalf, due to subpara. 6(1)(a)(i). Employees cannot deduct interest on money borrowed to make pension plan contributions (unless the contributions are required to be made under an obligation entered into before November 13, 1981)[78] and employers can only deduct such interest if the criteria in para. 20(1)(q) is met, effectively ensuring that the requirements under s. 147.2(1) or (10) must also be met in order to deduct any interest on funds borrowed to make pension plans contributions.[79]

Revocation of Registration

Subsection 147.1(6) provides that for each registered pension plan, a person or body of persons (the "administrator") shall bear ultimate responsibility for the administration of the plan. The administrator must be resident in Canada (except where permitted by Minister) and is responsible for administering the plan in accordance with terms of the plan as registered. Pursuant to subsec. 147.1(18) and the related regulations, the administrator is also required to calculate pension adjustments, past service pension adjustments, total pension adjustment reversals (as discussed further below) and certain other amounts, as well as provide information regarding

76. ITA, subsecs. 147.2(4)(a) and 8501(6.1).
77. ITA, paras. 147.2(4)(b) and (c).
78. ITA, subpara. 18(11)(c)(i).
79. ITA, subpara. 18(11)(c)(ii).

amendments to plans and file annual information returns and various reports.[80]

Failing to abide by an administrator's duties, as noted above, can result in the plan's registered status being revoked. Revocation of a plan's registered status has dire consequences and will generally mean that unregistered pension plan tax treatment will apply (possibly retroactively), *i.e.,* the plan will be treated as a retirement compensation arrangement ("RCA") and Part XI.3 tax will apply. Part XI.3 tax is equal to 50% of all contributions to the "custodian" of an RCA and the employer faces withholding liability for the contributions.[81] In addition, further 50% tax applies to the RCA's income from a business or property and the whole of its capital gains for the year. The tax is refunded to the custodian when amounts are distributed to the beneficiaries. The RCA trust itself is exempt from Part I tax.

The ITA prescribes a lengthy list of conditions that, if breached, can result in revocation. By virtue of para. 147.1(18)(b), numerous other conditions are prescribed in subsec. 8501(2) of the *Regulations* and are as follows:

- Only certain contributions can be made to the registered pension plan, namely those that are a member's contributions to a money purchase or defined benefit plan, "eligible contributions" paid by an employer under a defined benefit provision, and certain transfers from other tax deferred plans, among others.[82]
- Only certain distributions may be made from the plan, namely the payment of benefits, transfer to certain other registered plans, return of contributions for the purpose of avoiding revocation or pursuant to an amendment that reduces future contributions (for defined benefits plans), payment of interest on such refunded contributions and payments in satisfaction of an interest in an actuarial surplus, among certain others.[83]
- The assets of the plan must be held in an arrangement that is acceptable to the Minister[84] and cannot be "prohibited investments" (generally meaning investments in the employer or a person connected with the employer,

80. See *Regulations*, ss. 8401, 8402.01 and 8409.
81. ITA, para. 153(1)(p).
82. *Regulations*, para. 8502(b).
83. *Regulations*, para. 8502(d).
84. *Regulations*, para. 8502(g).

a member of the plan, or a person or partnership that controls or does not deal at arm's-length with either the employer, connected person or member, with some exceptions for publicly listed investments and pertaining to multi-employer pension plans)[85] or investments that are not permitted under the relevant pension legislation.[86]

- The borrowing of money can only be done on a short term basis (meaning 90 days, where the borrowing is not part of a series of loans or transactions), where none of the plan's property is used as security. Alternatively, money can be borrowed for the purpose of acquiring real property for the purposes of earning income, as long as the amounts borrowed do not exceed the cost of the property and the plan's other assets are not used as security for the loan;[87] and
- Amounts under the plan must be determined using reasonable assumptions acceptable to the Minister and in accordance with generally accepted actuarial principles (if applicable),[88] property cannot be transferred between benefit provisions unless it would qualify for such a transfer if the different provisions were treated as separate registered plans[89] and members must not be entitled to certain government-sponsored retirement arrangements.[90]

Defined benefit plans will also become revocable if the lifetime retirement benefits aren't provided in respect of "eligible service" periods (generally meaning periods of employment or eligible periods of temporary absence from such employment),[91] benefits continue to accrue after retirement,[92] there are breaches of restrictions on providing bridging benefits under more than one defined benefit plan[93] and paying out lump sums in satisfaction of benefit entitlements (that are deducted from

85. *Regulations*, para. 8514(1).
86. *Regulations*, para. 8502(h).
87. *Regulations*, para. 8502(i).
88. *Regulations*, para. 8502(j).
89. *Regulations*, para. 8502(k).
90. *Regulations*, para. 8502(m).
91. *Regulations*, para. 8503(3)(a).
92. *Regulations*, para. 8503(3)(b).
93. *Regulations*, para. 8503(3)(k).

entitlement under a plan)[94] or there are prepayments of member contributions,[95] among certain other conditions.

Similarly, defined contribution plans will also become revocable if employers make contributions that aren't tied to a particular member,[96] plan earnings aren't allocated to the members on a reasonable basis (with certain exceptions),[97] forfeited amounts aren't reallocated to members of the plan, participating employers or expenses of the plan,[98] or retirement benefits aren't provided by means of an annuity from a licensed annuities provider,[99] among others.

Another key condition that must not be breached is provided in 147.1(8), which states that a plan becomes a revocable plan if the "pension adjustment" (the "PA") exceeds the lesser of the money purchase limit or 18% of the member's compensation for the year.[100] The PA is a critical component of the Canadian pension taxation system and is discussed in more detail further below.

Transfers between Registered Plans

Section 147.3 outlines transfers between registered pension plans and other retirement savings vehicles, namely RRSPs and RRIFs, which includes making property of one plan available to pay benefits under another plan.[101] Transfers between the various plans are governed by subsecs. 147.3(1)-(3), generally requiring that the transfer be of a single amount (thereby prohibiting the transfers of periodic income between the various plans), directly transferred in full or partial satisfaction of the member's entitlement to benefits of the transferring plan to fund benefits under the receiving plan. Subsection 147.3(4.1) allows the transfer of actuarial surplus of a defined benefit plan to a defined contribution plan, while subsects. 147.3(5)-(8) provide for transfers between spouses, lump sum benefits on death, pre-

94. *Regulations*, para. 8503(3)(j).
95. *Regulations*, para. 8503(4)(b).
96. *Regulations*, para. 8506(2)(b).
97. *Regulations*, para. 8506(2)(e).
98. *Regulations*, para. 8506(2)(f).
99. *Regulations*, para. 8506(2)(g).
100. For multi-employer pension plans, the determination rests on whether the member's "pension credit" exceeds the money purchase limit or 18% of compensation, in ITA, subsec. 147.1(9). While "pension credits" are discussed in detail in this paper, conditions specific to multi-employer plans are beyond its scope.
101. ITA, subsec. 147.3(14).

1991 contributions and the transfer of all or a significant portion of member's benefits between plans, where one defined contribution plan wholly replaces another defined contribution or defined benefit plan.

By virtue of para. 147.3(9)(a), the transfers above are not subject to tax under subpara. 56(1)(a)(i), the provision generally providing for an income inclusion of pension benefits and other amounts. Conversely, para. 147.3(9)(b) provides that no deduction may be made by any taxpayer under any provision of the ITA in respect of the transferred amount. If the transfer between the various plans is not in accordance with subsecs. 147.3(1)-(8), the amount is deemed to have been paid to the individual member, who is then deemed to have paid that amount as a contribution to the receiving plan.[102] Therefore, if the amount exceeds the individual's contribution limit, the individual will face an income inclusion. Additionally, not complying with subsecs. 147.3(1)-(8) will make the plan become revocable.[103]

Transfers to Annuities

Finally, s 147.4 outlines the treatment of annuities. Subsection 147.4(1) deems an individual that acquires an interest in an annuity in full or partial satisfaction of their entitlement to benefits under a registered pension plan not to have received any amounts under the pension plan as a result and to receive any amounts subsequently paid out under the annuity from the pension plan (except for the purposes of ss. 147.1 and 147.3). The rights under the annuity cannot be materially different from those under the transferring registered pension plan, among certain other conditions.[104] If the annuity contract is amended to materially alter the rights of the beneficiaries, each individual that has an interest in the annuity will be deemed to receive a payment of an amount equal to the fair market value of their interest at that time, meaning a potentially substantial income inclusion.[105] New annuity contracts that are substituted for previous contracts will have the same effect unless the rights are not materially different, in which case the new contract will be

102. ITA, subsec. 147.3(10).
103. ITA, subsec. 147.3(12).
104. ITA, subparas. 147.4(1)(c)-(e).
105. ITA, subsec. 147.4(2).

deemed to be a continuation of and the same contract as the original contract, pursuant to subsec. 147.4(3).

The Factor of 9 and Pension Adjustment

One of the overarching and central themes of the Canadian pension taxation regime is the equitable treatment of all taxpayers, where the maximum amount of money that may be deducted from taxable income and contributed to a tax-assisted retirement savings plan should be consistent across the different various registered savings vehicles.[106] The contribution room for RRSPs is the point of departure, where individuals may contribute up to 18% of their previous year's earned income to an RRSP, up to a certain fixed dollar amount (currently $26,500).

However, while just about any taxpayer can establish an RRSP account and make tax-deductible contributions to such account, not all taxpayers have the benefit of membership in an employer's deferred profit sharing plan[107] or registered pension plan. Accordingly, given the tax deferred treatment given to those plans, those that have both an RRSP account and a registered pension plan could receive a much greater benefit in the form of extra tax-assisted retirement savings.

This is why the 1991 "Pension Reform" that enacted the detailed rules discussed above also brought in the "pension adjustment" ("PA") limits on registered pension plans and their beneficiaries. The PA effectively accounts for the value of benefits accrued under a registered pension plan in any given year and reduces RRSP contribution room accordingly, leveling the playing field between the "haves" and "have-nots".[108] With this system, those that both belong to a registered pension plan and hold an RRSP account cannot double up their contributions and are therefore, arguably, placed in the same position as those that don't have membership in a registered pension plan.

The PA has three distinct uses: determining RRSP room in a

106. Towers Watson, *Canadian Pensions and Retirement Income Planning*, 4th ed. (Toronto: CCH Canadian Ltd., 2010), at p. 65.

107. While these types of plans bear considerable relevance to the retirement savings regime, an in-depth discussion of them is beyond the scope of this paper.

108. James Pierlot, "A Pension in Every Pot: Better Pensions for More Canadians", The Pension Papers, No. 275 (Toronto: C.D. Howe Institute, November 2008).

year, limiting maximum contributions and benefit accrual for defined contribution and defined benefit plans (respectively, as discussed further below) and determining the maximum employee contributions to a defined benefit plan.[109] It is calculated annually but the overall retirement tax regime operates with a one-year lag, due to practical reasons. Ideally, the PA attributable to a pension plan member in any given year should reduce the RRSP contribution room for that particular year.[110] However, this would mean that the employee couldn't determine their RRSP limit for a year until the next year, which is when employers can determine and report the PA based on the accrued pension benefits of the previous year.[111] Similarly, the CRA requires time to calculate RRSP contribution room, based on 18% of an individual's earnings in a year. Accordingly, the amount of money an employee can contribute to their RRSP is based on their earnings and accrued pension benefits of the previous year.[112] Furthermore, because the PA is only reported at the end of February and creates a two month period where an individual may not know their RRSP room, the $2,000 limit of "error room" is provided for excess RRSP contributions and employees are subject to the 1% penalty tax on over contributions up to this amount.[113]

The calculation of the PA relies on the "pension credit", defined in subsecs. 8301(1)-(7) of the *Regulations* and is calculated differently based on the type of pension plan. It is generally meant to represent the amount of pension benefits accrued in respect of a particular individual in a given year. With respect to defined contribution plans, the measure of benefits accrued in a given year is more or less simple, generally being the amount contributed to the plan,[114] with additional voluntary contributions by employees generally being excluded (alongside certain other exceptions).[115]

For defined benefit plans, however, the calculation is much more complex because a defined benefit plan provides a pension based on a formula that multiplies a certain percentage (2% at

109. *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 87.
110. *Ibid.*, at p. 67.
111. *Ibid.*
112. *Ibid.*, at p. 67.
113. ITA, subsec. 204.1(2.1).
114. *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 66; and the *Regulations*, subsec. 8301(4).
115. *Regulations*, para. 8301(4)(a).

highest, as per the limit discussed above) by the number of years of pensionable service and then by the amount obtained through one of numerous possible measures of the employee's earnings (discussed further below). Accordingly, it is much more difficult to place a current value on the benefits accrued in a given year for a defined benefit pension plan. For example, the same contribution in a given year may yield higher benefits for younger employees versus older employees, with younger employees having many more years of pensionable service ahead of them and therefore more time for investment earnings to accrue.[116] Similarly, the type of plan, age, gender and marital status all have an impact on the amount of benefits an individual accrues, with the ideal PA calculation taking into account all of these factors for each particular individual in order to determine the actual amount of benefits accrued for any given year.[117]

The above task is extremely laborious and would be very difficult to do efficiently.[118] This is why the calculation of a PA for a defined benefit plan uses the "factor of 9". The factor of 9 is an actuarial estimate of what pension benefit accrual in a given year would be if that amount were converted to a lump sum contribution to a defined contribution plan.[119] The 1984 federal government proposals that led to the 1991 Pension Reform first introduced the factor of 9, based on the premise that that $9 of contributions was sufficient to buy $1 of target pension.[120] It was based on certain actuarial assumptions:

- The individual will retire at age 63, with an unreduced pension and 35 years of service;
- The pension will be indexed in line with the Consumer Price Index, less 1%; and,
- The pension plan member will have a spouse and the death benefit to the spouse is 60% of the initial benefit.[121]

116. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 66.
117. *Ibid*., at p. 66.
118. *Ibid*.
119. Robert Brown, "The Pension Factor of 9: Actuarial Logic Skewed by Political Myopia", Institute of Insurance and Pension Research Department of Statistics and Actuarial Science, University of Waterloo (2004), at p. 4.
120. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 116.
121. Brown, *supra*, footnote 119, at p. 5.

Needless to say, the above assumptions do not necessarily represent all beneficiaries and may produce an overstated PA which then reduces RRSP room beyond the pension benefits actually accrued in that year.[122] The factor of 9 has been criticized on various other grounds as well, including not creating the "level playing field" it's intended to create, due to the maximum benefit limits not being indexed in line with average wages.[123] Some authors have also criticized it for effectively favouring public pension plan beneficiaries over private pension plan beneficiaries due to understating the actual benefits earned by public pension plan beneficiaries.[124]

Nevertheless, the factor of 9 is a critical part of the current pension taxation regime. It comes into play in element A of para. 8301(6)(a) of the *Regulations*, which provides that an individual's "pension credit" (and thereby PA) for the year with respect to a defined benefit pension plan is the individual's "benefit entitlement" for the year, multiplied by 9. Element B subtracts the PA offset, currently $600. The "benefit entitlement" is defined in section 8302 of the *Regulations* and is the benefit accrual for the year, which is the "normalized pension" for the year.[125]

The "normalized pension" is a complex calculation but generally represents the accrued pension that an individual would be entitled to if they were to retire that very year. For the purposes of this calculation, one does not need to use the employer's actual method of calculating earnings in the defined benefit formula, *i.e.,* best average, final average or career average, and the benefit accrual can usually be calculated quite simply by taking the percentage in the formula and multiplying it by the pensionable earnings for the credited service in the year.

Using a simple example then, suppose an employee has a defined benefit formula of 2% x Years of Service x Career Average Earnings. They earn $50,000 in a particular year. The benefit entitlement for the year would be 2% x $50,000, which is $1,000. The PA would therefore be ($1,000 x 9) - $600 = $8,400. Of course, this is a very simplified calculation and the calculation of a PA is often much more complex. Defined

122. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 115.
123. Brown, *supra*, footnote 119.
124. Pierlot, *supra*, footnote 108.
125. *Regulations*, subsecs. 8302(2) and (3), respectively.

benefit pension plans often have formulas that provide for different percentages depending on whether earnings are less or more than the year's maximum pensionable earnings ("YMPE") and some have flat benefits with negotiated increases, which provide for an altogether different formula. Employees can also have partial years of credited service and be subject to a cap on pensionable earnings. As well, whether the earnings are annualized or not also makes a difference in how the PA is calculated. Accordingly, there are many instances where the more complex "normalized pension" calculation must be performed.[126]

The defined benefit PA doesn't include the employee's required contributions and certain ancillary plan benefits, such as early retirement subsidies, bridging benefits, pre-retirement death benefits, and post-retirement indexing. After an employee has reached the maximum credited service, no PA will be created as benefits cease to accrue. Transfers between registered plans (as described in the discussion of section 147.3 above) also do not create a PA as no difference in benefit entitlement has generally taken place (but see the discussion on past service pension adjustments below). As well, while unused PA room cannot be carried forward (unlike RRSP room), it does indirectly create RRSP room in the following year, which can be carried forward.[127] The PA does, however, include additional voluntary contributions to a defined benefit plan by employees.

Past Service Pension Adjustment

If the benefits in respect of past service are improved, a "past service event" may be considered to have taken place and a past service pension adjustment or "PSPA" may be created. The PSPA is an important component of the underlying policy of the pension taxation regime, namely that of equity. While the PA measures the value of the benefits that accrue in a current year (subject to the one year lag, of course), the PSPA serves to ensure equitable access to the retirement savings system by accounting for the potential undervaluing of previous PAs.[128] Equity requires measurement[129] in the pension taxation regime

126. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 125.
127. *Ibid.*, at p. 87.
128. *Ibid.*, at p. 163.
129. *Ibid.*, at p. 133.

and the PSPA is one of the more particularly complex calculations in this respect. Without the PSPA and prior to 1989, employees that had defined benefit pension plans could effectively double up on their tax assisted retirement savings by contributing the maximum amount to an RRSP and then having an employer set up a defined benefit pension plan that provided past service benefits in respect of those years.[130]

As mentioned above, the PSPA depends on the key concept of a "past service event", defined in subsec. 8300(1) of the *Regulations* as any transaction, event or circumstance that results in benefits under a defined benefit pension plan being provided for the period prior to the event, a change to the way such retirement benefits are determined for the period prior to the event or a change in the value of an indexing or other automatic adjustment of benefits, again in respect of the period prior to the event.

Practically speaking, some examples of where a PSPA is generally created are a purchase of prior service (*i.e.,* a service "buy-back), improvements to a defined benefit formula (*i.e.,* 1.5% is increased to 2%) or a transfer of benefits under a reciprocal transfer or portability agreement where the new employer credits the same years of service but has a more advantageous defined benefit formula.[131] Had those benefit improvements been in place at the time, a higher PA would have been reported. This is why the PSPA is effectively the sum of the unreported PA amounts for the years in question.

There are two methods for calculating the PSPA – the basic approach and the modified approach. The basic approach relies on the following formula:

$$A - B - C + D$$

Element A is effectively the amount of the improvement, being the pension credits that should have been reported at the time if the benefit improvement had always been in place. Element B is any benefit improvements already accounted for in previous PAs and PSPAs. C is the total of the amounts subject to a "qualifying transfer" (*i.e.,* amounts subject to transfers between registered plans under s. 147.3, as described above, among other transferred amounts),[132] which will have been

130. *Ibid.*, at p. 163.
131. *Ibid.*, at pp. 164-165.
132. Subsection 8303(6) of the *Regulations*.

"accounted for" in previous PAs[133] and element D is the "excess money purchase transfer",[134] which reflects the extent to which tax sheltering was received but not accounted for in previous PAs or PSPAs.

The basic approach is generally used where previous benefits are improved, past service is credited (*i.e.,* service buy-backs) or an employee terminates employment, receives a pension adjustment reversal or "PAR" (discussed further below) and is then reinstated.[135] The modified approach, however, usually comes into play when there has been a transfer of benefits pursuant to a reciprocal transfer or portability agreement and the relative differences between the PAs of the former plan and new plan must be accounted alongside the impact of the actual asset transfer.[136] It is also used where an employee receives a reinstatement of benefits that were foregone and no PAR was reported.[137]

The modified approach formula effectively ensures that any opportunities to duplicate benefits and excess tax sheltering are constrained; thereby preventing "double-dipping"[138].The modified approach uses the following formula:

$$A + B + C - D$$

Element A is effectively (A-B) of the basic approach formula, but also includes the year of the past service event (whereas the basic formula does not). Element B is pre-1997 service adjustment due to the "year of non-vested termination rule", a rule that was in effect prior to the introduction of the PAR (described further below).[139] Element C is the money purchase transfer amount, *i.e.,* the amount of funds of the old plan that are transferred into an RRSP (or certain other plans) rather than the new plan. This reflects the amount by which the old benefits exceed the "reduction" in PA value of the new benefits, due to the move.[140] Element D is the amount of a qualifying transfer (identical to element C in the basic approach formula).

133. *Ibid.*, at p. 183.
134. Subsection 8303(7.1) of the *Regulations*.
135. *Ibid.*, at p. 181.
136. *Ibid.*, at p. 184.
137. *Ibid.*
138. *Ibid.*, at p. 184.
139. A detailed discussion of this rule is beyond the scope of this paper.
140. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at p. 18.

A PSPA is not created when there are changes in the earnings formula (*i.e.,* changing between a Best of 5 Years average to a Career Average and vice versa), improvements in ancillary benefits or increases in a pension credit resulting from the indexation automatically factored into the maximum permissible lifetime retirement benefit,[141] among numerous other changes.

Through the PSPA, equity is arguably achieved by ensuring that previous increases in benefit entitlement for defined benefit plan beneficiaries (that weren't accounted for in the PA at the time) are accounted for in reducing RRSP room accordingly, thereby ensuring that the "haves" are treated consistently with the "have-nots". Of course, this requires the assumption that the PA and PSPA together account for the major inconsistencies and inequities in the pension taxation regime.

Pension Adjustment Reversal

The assumption mentioned directly above does not always hold true. In fact, as discussed, using the factor of 9 to determine the PA can considerably overstate the pension benefits that a younger member has accrued in a year and thereby unfairly reduce RRSP contribution room.[142] While the 1984 proposals addressed this by stating that the benefits for older members are generally understated, suggesting that overall balance is nevertheless achieved, they also included something else — a proposal for the PAR. Initially meant to be part of the original 1990 amendments, the PAR was dropped in an effort to reduce administrative complexity. This brought about serious concern, particularly given that the policy behind the Pension Reform was equitable treatment. The compromise was initially to have a higher PA offset of $1000. Nevertheless, the federal government brought the PAR back in 1997, as the third major component of the policy of equitable treatment in the pension plan taxation regime.

As the PA does not account for, and isn't representative of, all individual factors (as discussed above) it is more likely than not that when a plan member receives a benefit payout on termination of membership of a defined benefit pension plan, this amount will be different than the previous PAs and PSPAs. Accordingly, the essence of the PAR is to restore RRSP room where an individual terminates plan membership and the payout

141. *Ibid.*, at pp. 173-174.
142. Brown, *supra*, footnote 119, at p. 5.

received is less than the cumulative previous loss of RRSP room caused by the PA and PSPA amounts. In other words, the PAR takes the amount by which an individual's RRSP contribution room has been reduced over the years by PAs and PSPAs and subtracts the actual amount of benefits accrued under the defined benefit plan in respect of those years, as represented by the lump sum payout. As the PA tends to overstate the benefits accrued, the lump sum payment will usually be less and RRSP room will be increased by the amount of the difference.

The calculation of the PAR is therefore more or less straightforward. It is described in subsec. 8304.1(5) for defined benefit plans and entails taking the total amount of all of an individual's PAs and PSPAs[143] and subtracting the amount of the lump-sum payout received, if paid after 1996.[144] If the amount is positive, a PAR will be reported. The formula for calculating the PAR is as follows:

$$A + B - C - D$$

Element A is the sum of the member's pension credits, being the lesser of the actual pension credits and the RRSP dollar limit for the following year. Element B is the sum of the grossed-up amounts of PSPAs, effectively taking into account the PA value related to past service benefits. Element C is the amount of the "specified distribution", generally the commuted value of the benefit or any other lump sum paid to the member, transferred to an RRSP or to a defined contribution plan (not including the return of excess contributions paid out in cash due to the limit on transfers between defined benefit plans).[145] Finally, Element D is the PA transfer amount, which generally only arises in the case of a reciprocal transfer or portability arrangement. It is effectively the lesser of the PA value of the past service benefits under the importing plan and the PA value of the benefits under the exporting plan, calculated in subsec. 8304.1(10).[146] This number will usually only be positive if the importing plan provides less generous benefits than the exporting plan (thereby resulting in a PAR of the amount of the difference).[147]

143. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106, at pp. 216.
144. *Ibid.*, at pp. 216.
145. *Ibid.*, p. 218.
146. *Ibid.*, p. 223.
147. *Ibid.*, p. 224.

Practically speaking, a PAR will arise when a member receives a lump sum payout of their commuted value and transfers it to another vehicle of a money purchase nature or terminates before vesting. A PAR will also generally occur when a member is subject to a conversion of their defined benefit entitlement to a defined contribution entitlement, upon benefit payout in the case of plan wind up and if the PA value of the benefits of an exporting plan exceed the PA value of the importing plan in a reciprocal transfer/portability scenario, as mentioned above.[148]

While it is the employer that must generally report the PA (except in certain cases), it is the pension plan administrator that must calculate and report the PA, PSPA and the PAR (as mentioned above). This requires collaboration and the timely transfer of information between employers and plan administrators. Often, one's obligations cannot be fulfilled without the other. For example, an employee transferring between plans pursuant to a reciprocal transfer or portability arrangement can be subject to either a PSPA (if granted past service benefits in the importing plan that are higher than those of the exporting plan) or a PAR (if the importing plan provides lesser benefits and the exporting plan pays out a lump sum to the employee as a result). The importing plan needs certain information from the exporting plan in order to determine whether a PSPA has arisen, and the exporting plan cannot calculate the PAR until the importing plan also provides key information.[149] The exporting plan needs to provide the importing plan with the benefits provided in the plan so that the importing plan can determine Element C in the PSPA formula (the modified approach). The modified PSPA can then be calculated and the "PA transfer" amount reported to the exporting plan, which is required for calculating the PAR (Element D).[150] Timing requirements complicate the exchange of information and impose further administrative complexity.[151] Accordingly, cooperation among employers and administrators (on both sides, in the case of a reciprocal transfer) is critical to effective implementation of the PA/PSPA/PAR system and often means considerable costs and expenditures on the administrative and compliance components of sponsoring and administering

148. *Ibid.*, at pp. 213-214.
149. *Ibid.*, p. 198.
150. *Ibid.*, at p. 222.
151. *Ibid.*, p. 196.

pension plans. This task can become quite substantial when one considers plan amendments and employee termination and transfer, particularly for large plans with members in multiple provinces.

The Investment Stage – Tax-Exempt Entities

As the second stage of the "EET" pension system, the earnings of a pension plan are generally exempt from tax under Part I of the ITA. However, given that this arguably comprises the most important component of a pension plan, *i.e.,* the management of its assets for the purpose of funding the pension promise to retirees, the rules in the ITA surrounding pension plan investments are detailed and prescriptive and expressly require compliance with pension legislation. In fact, as discussed above, a pension plan's registered status may become revocable if any of its investments are not permitted under the federal *Pension Benefits Standards Act*[152] ("PBSA") or equivalent provincial legislation.[153]

The pension legislation imposes certain limits and parameters on a pension plan's investments, such as the requirements for a Statement of Investment Policies and Procedures ("SIP&P") in sections 6, 7, 7.1 and 7.2 of the PBSA Regulations, and the quantitative restrictions in the "Permitted Investments" requirements in Schedule III of the PBSA Regulations ("Schedule III"), among other restrictions (such as restrictions on related party transactions). Schedule III has been adopted by reference into most provincial statutes, including the Ontario *Pension Benefits Act*[154] ("PBA").[155] Both the federal statute and provincial legislation also impose fiduciary duties and standards of care with respect to the management of a pension plan's investments, such as the "ordinary prudence" standard in s. 22 of the PBA.

The Schedule III requirements impose two key quantitative limits, known as the 10% Rule and 30% Rule. The 10% Rule prohibits a pension plan from investing more than 10% of the total "market value" of the plan's assets directly or indirectly in any one person or any two associated persons or affiliated corporations, including through debt.[156] This rule doesn't apply

152. *Pension Benefits Standards Act*, *1985*, R.S.C. 1985, c. 32 (2nd Supp.).
153. Paragraph 8502(h) of the *Regulations*.
154. *Supra*, footnote 2.
155. See s. 79 of *General*, R.R.O. 1990, Reg. 909 under the PBA.

in respect of funds held by bank, trust and loan companies and other financial institutions that are fully insured as prescribed in the PBSA Regulations[157] and investments in the following:

- an investment fund or a segregated fund that complies with the PBSA Regulations;
- an unallocated general fund of a person authorized to carry on a life insurance business in Canada;
- an investment corporation, real estate corporation or resource corporation (described in further detail below);
- securities issued or fully guaranteed by the Government of Canada, the government of a province, or an agency thereof;
- a fund composed of mortgage-backed securities that are fully guaranteed by the Government of Canada, the government of a province, or an agency thereof; or
- a fund that replicates the composition of a widely recognized index of a broad class of securities traded at a marketplace.[158]

The 10% Rule applies at the level of the pension fund's assets and not at the level of the investment entity in question.[159] Accordingly, the 10% Rule seeks to ensure that a pension plan's investments are sufficiently diversified or are otherwise invested in investments that can be generally considered more conservative and therefore less risky. The court in *R. v. Christophe*[160] pronounced on the diversification point accordingly:

> The court finds that the purpose of this provision, that the administrator of a plan not directly or indirectly lend or invest moneys of the plan equal to more than 10 per cent of the total book value of the plan's assets, is to ensure adequate diversification of the investments and loans of the pension plan. This provision captures any acts such as advances

156. Section 9 of Sch. III.
157. F.D. Guarascio, J.J. Forgie, and J. Trossman, "Pension Fund Investment Issues", 2010 CBA/IPEBLA Pension and Benefits Law Conference (May 21, 2010), at p. 9.
158. Subsection 9(3) of Sch. III.
159. While there had been a long-standing debate on this point, the CRA's most recent position has clarified that the 10% Rule applies at pension fund level, in CRA Views Document 2013-0508321I7 - Pension corporations - 149(1)(o.2)(iii).
160. 2009 ONCJ 586 (Ont. C.J.).

> during the offence period which would result in the holdings of the plan being in excess of the quantitative limits. . . . The provision is in place to ensure the overall diversification of the plan and to minimize the danger which would result if there is too great a concentration of risk in any one "person." Accordingly, the provision targets the overall amount held in any one place, such that there not be any new advances which would result in holdings beyond the quantitative limits.

The 30% Rule, on the other hand, provides that the administrator of a pension plan shall not, directly or indirectly, invest the funds of a pension plan in the securities of a corporation to which are attached more than 30% of the votes that may be cast to elect the Board of Directors.[161] According to the federal Government of Canada, the principal reasons for the 30% Rule are that pension plans should generally remain passive investors that do not take part in the management of the day-to-day affairs of a business (where any investment above a 30% stake is arguably considered to be active participation in a company's affairs) and to reduce the pension plan's exposure to the risk of failure of the controlled business.[162] It has also been suggested that the rule may be necessary to level the playing field between pension funds and other institutional investors, given that the pension fund's tax-exempt status arguably gives the pension fund an advantage in the open market because of a lower cost of capital.[163]

This rule has been the subject of considerable criticism and various stakeholders have suggested that the rule should either be relaxed or abolished entirely, with a higher emphasis on an expanded prudence test so that pension funds with the requisite level of sophistication can partake in the affairs of a business on a more active basis.[164] Structures and arrangements have also been devised to circumvent the rule altogether, casting considerable doubt on its effectiveness.[165]

Much like the 10% Rule, the 30% Rule does not apply to "investment corporations", "real estate corporations" or "resource corporations", provided certain steps are taken by

161. Subsection 11(1) of Sch. III.
162. Canada, Department of Finance, "Pension Plan Investment in Canada: The 30 Per Cent Rule", Consultation News Release (September 2016).
163. See Vijay Jog and Jack Mintz, "The 30 Percent Limitation for Pension Investment in Companies: Policy Options" (2012), 60 Can. Tax J. 567, at p. 568.
164. Guarascio, Forgie, and Trossman, *supra*, footnote 157, at p. 13.
165. Jog and Mintz, *supra*, footnote 163, at p. 570.

the administrator.[166] These are defined in Schedule III, where an "investment corporation" is a corporation that: (i) is limited in its investments to those that are authorized for the plan under Schedule III; (ii) holds at least 98% of its assets in cash, investments and loans; (iii) does not issue debt obligations; (iv) obtains at least 98% of its income from investments and loans; and (v) does not lend any of its assets to, or invest any of its moneys in, a related party of the plan.[167] In turn, a "real estate corporation" must be a corporation incorporated to acquire, hold, maintain, improve, lease or manage real property (other than real property that yields petroleum or natural gas).[168]

Finally, a "resource corporation" is a corporation that has, at all times since the date on which it was incorporated: (i) limited its activities to acquiring, holding, exploring, developing, maintaining, improving, managing, operating or disposing of Canadian resource properties; (ii) restricted its investments and loans, other than investments in Canadian resource properties or property to be used in connection with Canadian resource properties owned by it and loans secured by Canadian resource properties to persons resident in Canada for the exploration or development of such properties, to investments and loans authorized for a plan under this Schedule; and (iii) not borrowed money other than for the purpose of earning income from Canadian resource properties.[169]

The ITA rules that provide tax-exempt status to pension entities contain similar special purpose corporations, albeit with some key additional requirements and differences. The ITA equivalent to the Schedule III "real estate corporation" is the entity prescribed in subpara. 149(1)(o.2)(ii), which is a corporation that must limit its activities to acquiring, holding, maintaining, improving, leasing or managing real property, immovables or a real right in immovables,[170] or investing in a partnership that is identically limited with respect to its activities and investments.

166. In order to be exempt from the 30% Rule, however, the administrator of the pension plan must file an undertaking with the Office of the Superintendent of Financial Institutions ("OSFI") on behalf of the corporation in question that the corporation will comply with the investment restrictions, not lend money to or invest in related parties and provide access to certain information, among other certain requirements.
167. Schedule III, s. 1.
168. *Ibid.*
169. Schedule III, s. 1.
170. ITA, cl. 149(1)(o.2)(ii)(A).

Unlike the Schedule III entity, however, the subpara. 149(1)(o.2)(ii) corporation must have limited its activities, investments and borrowing (as described further below) at *all times* since incorporation. In addition, the subpara. 149(1)(o.2)(ii) corporation cannot "invest" in anything other than real property or interests in real property, or investments that aren't permitted under Schedule III,[171] suggesting there may be a difference between "activities" and "investments".[172] Finally, the real property, immovables or real right in immovables must be held on capital account, *i.e.,* not be used as inventory of a business, and money can only be borrowed solely for the purpose of earning income from real property, immovables or real right in immovable.[173] Accordingly, a subpara. 149(1)(o.2)(ii) corporation must be a passive investor in real property (or a partnership that only invests in real property)[174] that complies with Schedule III requirements and only borrows funds to earn income from real property.

Nearly identical requirements apply to subpara. 149(1)(o.2)(ii.1) corporations, the ITA equivalent to a Schedule III "resource corporation", with respect to activities, investments and borrowing restrictions for Canadian resource properties. These entities, however, do not appear to be able to invest in a partnership. Additionally, Schedule III also has a borrowing restriction for "resource corporations", whereas no such restriction exists for "real estate corporations", which are therefore restricted from borrowing under the ITA only. As well, interestingly enough, while there is no requirement in the ITA that a subpara. 149(1)(o.2)(ii.1) corporation limit its activities, investments and borrowing (as described above) at *all times* since incorporation, there is such a requirement in Schedule III. This is the opposite of subpara. 149(1)(o.2)(ii) corporations, which are so limited under the ITA but not under Schedule III. This is, of course, a distinction without a

171. ITA, cl. 149(1)(o.2)(ii)(B).
172. Guarascio, Forgie and Trossman, *supra*, footnote 157, at pp. 24-25.
173. ITA, subcl. 149(1)(o.2)(ii)(A)(I) and cl. 149(1)(o.2)(ii)(C), respectively.
174. While limited partners are generally prohibited from actively engaging in the business of the partnership under partnership legislation, they are generally considered to carry on the business of the partnership for purposes of the ITA. This could arguably breach the restrictions on the activities of the subpara. 149(1)(o.2)(ii) corporation, as per cl. 149(1)(o.2)(ii)(A). Accordingly, s. 253.1 of the ITA provides that a subpara. 149(1)(o.2)(ii) corporation is not considered to carry on the business of the partnership for the purposes of these rules (among others).

difference as the ITA requires compliance with the PBSA or provincial pension legislation in any case (as discussed above).

Finally, subpara. 149(1)(o.2)(iii) corporations are the ITA equivalent to Schedule III "investment corporations". The assets of these entities must be at least 98% comprised of cash and investments and the corporation's income must also be at least 98% derived from investments or the disposition thereof,[175] as identical to Schedule III requirements. These entities also cannot accept deposits, issued bonds, notes, debentures or "similar obligations",[176] and are therefore nearly identical to Schedule III entities, which cannot issue "debt obligations".[177] One important difference, however, is that all of the shares and rights to acquire shares of subpara. 149(1)(o.2)(iii) corporations must belong to one or more registered pension plans, trusts or segregated fund trusts with only registered plan beneficiaries and certain other prescribed pension plan-related entities, such as the Canada Pension Plan Investment Board.[178]

Aside from the three entities described above, pension trusts,[179] corporations that are operated for the administration of a pension plan,[180] and master trusts[181] are also granted tax-exempt status. These entities are not expressly granted exception from the 10% Rule and 30% Rule, under Schedule III.

The Pay-out Stage

The final component of the Canadian pension taxation system, the "T" in EET, is the decumulation stage, *i.e.*, when the pension is actually paid out to members after retirement. The benefits are paid periodically[182] (as per the requirements discussed above) and are included in the retirees' income due to subpara. 56(1)(a)(i), which includes in income any amount received as, on account of or in lieu of payment of, or in

175. ITA, cls. 149(1)(o.2)(iii)(A) and (C), respectively.
176. ITA, cl.149(1)(o.2)(iii)(B).
177. *Ibid.*, Sch. III, s. 1.
178. See s. 4802 of the *Regulations*.
179. ITA, para. 149(1)(o).
180. ITA, para. 149(1)(o.1).
181. See ITA, para. 149(1)(o.4) — these are trusts that have limitations similar to the investment and borrowing limits for the real estate, resource and investment corporations and have only registered pension plan and certain other registered retirement plans as beneficiaries.
182. Certain lump-sum payments can be directly rolled over into an RRSP, such as payments out pension plans that aren't registered or foreign retirement plans. See para. 60(j).

satisfaction of a superannuation or pension benefit. Subparagraph 56(1)(a)(i) expressly includes spousal allowances under the *Old Age Security Act*[183] ("OAS") and CPP benefits, among others.[184] An exclusion is provided for payments received under an RCA, returns of contributions, death benefits under s. 71 of the *Canada Pension Plan Act*,[185] and certain other payments.[186]

A non-refundable tax credit is provided to individuals in respect of pension income, including bridging benefits,[187] in the amount of $2,000 (effectively $300, plus the parallel provincial credit amount) under subsec. 118(3). Pension payments do not retain their character as pension payments if paid out through a testamentary trust (now a graduated rate estate),[188] however, an election can be made under subsec. 104(27) which can facilitate the flow-through of the pension tax credit to a spouse or child beneficiary. Individuals that attain 65 years of age also receive a non-refundable "age credit" in the amount of $6,408 (indexed for inflation after 2006 under section 117.1, currently $7,333), effectively being $1,099.95. However, this credit is provided for low-income seniors and, accordingly, subsec. 118(2) provides for a reduction in the age tax credit for individuals with income over $25,921 (also subject to indexation, the income threshold is $36,976 for 2018). The credit is fully phased-out when net income reaches $85,863 (for the 2018 taxation year).

In addition to taxing pension income under the ITA, certain public age related benefits, such as the guaranteed income supplement ("GIS") under OAS, are reduced for higher income seniors. Some authors have argued that this "clawback" effectively results in disproportionately high effective tax rates on seniors, particularly at the lower income levels where the entire benefit may be taken away, resulting in an effective tax rate in excess of 100%.[189] While a detailed discussion of this point is beyond the scope of this paper, numerous studies and authors have concluded that the high effective tax rates are likely to discourage saving for retirement.[190] Accordingly, as

183. *Old Age Security Act*, R.S.C. 1985, c. O-9.
184. See ITA, cl. 56(1)(a)(i)(A)-(C.1).
185. *Canada Pension Plan*, R.S.C. 1985, c. C-8.
186. See ITA, cl. 56(1)(a)(i)(D)-(G).
187. See ITA, subsec. 118(8.1).
188. ITA, subsec. 108(5) deems all income from a trust to be income from property that is a trust interest, except as otherwise provided in Part I of the ITA.
189. Laurin and Poschmann, *supra*, footnote 15, at p. 7.

considered in the main thesis of this paper in the next section, if we are to promote a sustainable retirement system through favourable tax treatment of retirement savings vehicles, it is important that we consider the actual impact on retirees during decumulation and not merely the contribution and investment stages.

4. Reducing the Tax Burden

As discussed in the first portion of this paper, pension plans in Canada, particularly defined benefit plans, appear to be on the way out, bringing the third pillar into question and drawing efforts to ensure adequate retirement support remains. Gone are the years of steady returns on secure government bonds and surplus accumulation. The secure promise model of the defined benefit plan is giving way to models that allow for the absorption of economic shocks as a means of sustainability and survival.[191] This generally entails allowing for the reduction of benefits or increase of contributions when the plan underperforms, *i.e.,* the target benefit plan model. As well, with the influx of defined contribution pension plans, the ability to pool risk associated with defined benefit pension plans is also being reduced, leading to certain attempts at innovation, such as pooled registered pension plans — essentially defined contribution pension plans that allow the pooling of contributions in order to achieve lower costs for investment management and plan administration.

The recent amendments to CPP also appear to be part of the effort. Beginning in 2019, the current 4.95% contribution rate will begin to gradually increase, culminating in an overall increase of one percentage point by 2023 (for both employer and employee). Beginning in 2024, a second earnings limit, known as the "year's additional maximum pensionable earnings" limit or "YAMPE" will be introduced. Earnings above the first ceiling ("the YMPE") will now also be subject to contributions, resulting in overall increased benefits that are projected to replace one-third of the average Canadians pre-retirement

---

190. *Ibid*., see also Richard Shillington, "New Poverty Traps: Means-Testing and Modest-Income Seniors", *Backgrounder* (Toronto: C.D. Howe Institute, 2003); and Jonathan Kesselman and Finn Poschmann, "A New Option for Retirement Savings: Tax-Prepaid Savings Plans", C.D. Howe Institute Commentary 149 (Toronto: The Institute, February, 2001).
191. Leech and McNish, *supra*, footnote 7, at p. 158.

earnings (as compared to one quarter under the previous CPP contribution levels).

Despite these efforts, more and more writings appear to discuss the challenges of the Canadian retirement system and the need for reform, particularly with respect to defined benefit plans. For example, a recent study by the World Bank commends the success of the Canadian pension plan and attributes it to the "Canadian Pension Model" of superior governance, economies of scale, innovative investment practice, responsible funding, visionary leadership, high pay, and certain other virtues.[192] It applauds the collaborative efforts of labour, government, business and finance in achieving a sturdy retirement system that has resulted in the top 10 defined benefit public sector pension plans in Canada collectively managing $1.2 trillion assets as of 2017.[193] This study nevertheless outlines seven challenges of Canadian pension plans.

The first of these challenges is mentioned numerous times in this paper already, being that lower expected returns and interest continue to make it more difficult to meet pension promises on a sustainable basis. This is leading funds to seek new investment strategies, as the conventional 60/40 portfolio split between equities and percent fixed-income struggles to achieve the necessary returns.[194] Accordingly, funds are seeking returns elsewhere and turning to less liquid investments such as infrastructure, real estate and private equity.[195]

The second challenge described in the study is that pension plans are maturing and the ratio of active plan members to retired plan members is decreasing considerably.[196] This is putting pressure on plan sustainability and raising questions of intergenerational equity.[197] Accordingly, plans are changing plan design and seeking new sources of membership.[198]

Thirdly, the study raises the issue of a simmering "pension envy",[199] where a gap between the pension "haves" (those who

192. Hamilton and Cross, *supra*, footnote 51, at p. 1.
193. World Bank, *The Evolution of the Canadian Pension Model: Practical Lessons for Building World-Class Pension Organizations (English)* (Washington, D.C.: World Bank Group, 2017), at pp. ix and 1.
194. *Ibid.*, at p. 67.
195. *Ibid.*
196. *Ibid.*
197. *Ibid.*, at p. xv.
198. *Ibid.*
199. *Ibid.*, at p. 68.

have a solid, well-funded, well-performing defined-benefit pension plan) and "have-nots" (those without a workplace pension plan or with a lower quality pension plan) is growing.[200] This leads to growing resentment and some fear that it could also lead to policy actions that undermine the benefits for the "haves", instead of supporting and assisting the "have-nots".[201]

The fourth and fifth challenges concern the complexity that results from the growth of Canadian pension organizations (as funds expand into new geographies and asset classes and compete globally for attractive investment opportunities) and the fragmented regulatory environment (both in Canada and globally, particularly in the wake of the 2008 global financial crisis).[202] Finally, demonstrating value for increasingly inquisitive stakeholders and preparing for the next major market downturn or financial crisis are the remaining two challenges pointed out in the study. The latter is particularly prominent and requires ongoing and effective communication between governments, sponsors, employers, financial institutions and retirees.[203]

The solutions to the above challenges are generally sought in good governance, effective investment strategy, cooperation and communication among different stakeholders and harmonizing and changing pension laws, including reducing strict funding requirements and allowing for new models of pension plans to take stage. Interestingly enough, however, while the burden on taxpayers that results from an ailing and impoverished senior population is often discussed and used as a factor to argue for the continued effort to maintain the sustainability of pension plans,[204] little attention has been devoted to the topic of whether the pension taxation regime can be modified to assist the sustainability of pension plans and promote their continued use in the workplace (beyond the traditional discussion of promoting savings through offering tax-deferred savings plans). One such consideration is the heart of this paper and is discussed next.

---

200. *Ibid.*
201. *Ibid.*
202. *Ibid.*
203. *Ibid.*, at p. 70.
204. Leech and McNish, *supra*, footnote 7, at p. 146.

4.1 The Tax Attributes

As discussed above in the component of this paper that outlines the various pension investment entities, pension plans are not subject to taxation on the investment earnings that they accumulate nor are the members subject to taxation on the accrual of the benefits during the investment earning stage (unlike, for example, the accrual taxation that ensues in cases of non-exempt life insurance policies). This is, of course, part of the consumption taxation approach we take with Canadian retirement savings vehicles under the ITA, in following the EET model.

During this stage, as no tax is imposed on the particular investment entity realizing investment earnings, there is no need to even calculate the tax that the entity would otherwise owe.[205] This is certainly beneficial in numerous respects, given the reduced administrative burden (as no time or resources need to be spent on calculating, reporting and remitting taxes) and the tax deferral itself, which results in a lower cost of capital for pension plans,[206] giving them a competitive advantage in the marketplace. Tax deferral in general is immensely beneficial in itself as is discussed in detail later in this paper.

However, as a result of the above, pension investment entities do not calculate and account for the various machinations and formulae of different types of income in the ITA. These machinations and formulae provide for reductions of that income, based on certain principles of equity and fairness. Capital gains treatment, for instance, provides that only one-half of a taxpayer's capital gain is a taxable capital gain. Effectively, the tax rate on income realized in a capital gain is halved. One of the main principles behind capital gains treatment is a means to account for the inability to account for inflation of the basis in an asset.[207] To use an example, suppose one purchased a parcel of real estate for $100,000 in 1990, and then sold it for $1,000,000 in 2020. The gain realized would be $900,000, however, to tax the entire amount would not account for the fact that the $100,000 adjusted cost base ("ACB") is, in 1990s dollars, likely worth considerably more today. Accordingly, only

205. Forman, *supra*, footnote 54, at p. 324.
206. Jog and Mintz, *supra*, footnote 163.
207. Peter W. Hogg, Joanne E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 8th ed. (Toronto: Carswell, 2013), at p. 319.

half of the gain is taxed under capital gains treatment, as we do not otherwise adjust the ACB for inflation.

With respect to pension plans, the question of capital gains treatment (while not directly applicable, due to the tax-exempt status) appears to be becoming more and more relevant, given that investment mandates are moving away from traditional equity and debt portfolios and into assets such as real estate, which is a more illiquid asset and is therefore more likely to be held on capital account. Further, as described in detail above in the portion of this paper that discusses the various tax-exempt investment entities, the ITA real estate corporations are limited to acquiring, holding, maintaining, improving, leasing or managing *capital property* that is real property.[208] Similarly, as discussed above in the portion of this paper that outlines pension plan registration requirements, pension plans are limited in the borrowing of funds, such that the borrowed money must be used to acquire real property for the purpose of producing income from property.[209] This also suggests that the real property must be held on capital account, as earning income from buying and selling real estate would generally be considered income from business.

Accordingly, were pension plans and their related investment entities not otherwise tax-exempt, capital gains treatment would be an important component of the filing position taken by a pension plan and would likely account for a considerable portion of reductions of the taxable income of the pension plan. However, what happens instead is that when the payout stage is entered into, income that would have otherwise been subject to capital gains treatment (were it taxed in the hands of the pension plan or its related investment entity) is in fact taxed as regular income in the hands of the retired pension plan member, *i.e.,* without the benefit of the halving treatment. As discussed in detail above in the portion of this paper that considers the decumulation stage or the "T" of the EET system, the retirees receive a certain amount of pension and age-related tax credits but the income is otherwise subject to a full inclusion under subpara. 56(1)(a)(i) of the ITA.

Notwithstanding the benefit of the tax-deferral (discussed further in this paper), this is tantamount to double taxation as the income would have otherwise been taxed at half the rate. Coupling this with the fact that retirees are already subject to

208. ITA, subcl. 149(1)(o.2)(ii)(A)(I).
209. *Regulations*, para. 8502(i).

extremely high effective tax rates with respect to reductions of first pillar benefits such as GIS and are part of a vulnerable cohort, it seems quite inequitable that the retirees also pay double the tax on some of the pension income they've earned through years (and possibly decades) of labour force participation and contributions.

Capital gains treatment is not the only instance where beneficial tax attributes are not useable due to the pension plan's tax-exempt status and result in retirees paying taxes they wouldn't have otherwise paid. Another worthwhile example is the dividend tax credit, a key component of corporate integration. The dividend gross-up and credit mechanism is the key to integration under Canadian corporate taxation and is complex, having many moving parts.[210] The purpose behind integration is neutrality and avoidance of double taxation — we tax dividends at a lower overall effective tax rate so as to account for the taxes paid at the corporate level. The effect is that the notional total tax paid on pre-tax corporate income is nearly equivalent to what it would have been if the underlying income was paid directly to the shareholder. The role of integration in neutrality can be described as follows: "if the shareholder 'sees through' the corporation and considers all taxes as equivalent, then she should be indifferent between investing in bonds that pay interest that is deductible from corporate tax and shares that pay dividends that are not deductible."[211]

To use an example, suppose a corporation earns $100 of income and is taxed at a rate of 26.5%. The corporation pays the shareholder a dividend of $73.50, the remaining after-tax amount. The dividend is grossed up by 38%,[212] resulting in $101.43 in taxable income to the shareholder. Assuming the shareholder pays taxes at the top marginal tax rate of 53.53%,[213] the personal tax payable on the grossed-up dividend is $54.29. However, the taxpayer is also eligible for a tax credit of 15.02% federally and 10% provincially,[214] which amounts to $25.36 and reduces net tax payable to $28.93, meaning an effective combined federal and provincial tax rate of

210. Michael Smart, "The Taxation of Dividend Income in Canada", Finances of the Nation feature (2017), 65 Can. Tax J. 419, at p. 420.
211. *Ibid.*, at p. 421.
212. ITA, cl. 82(1)(b)(ii)(D).
213. Combined federal and Ontario.
214. ITA, cl. 121(b)(iv).

39%. When the notional corporate tax rate is added to this, the overall effective tax rate becomes 55.54%, nearly equivalent to the 53.53% combined top marginal rate for individuals.

The dividend gross-up and credit rate discussed above is the rate for "eligible dividends", generally dividends that arise out of income of the corporation that is not subject to lower tax rates, such as income subject to the small business deduction for Canadian-controlled private corporations.[215] Non-eligible dividends are subject to lower gross-up and tax credit rates, to take into account the lower notional amount of corporate tax paid. Importantly, however, there is no requirement in the ITA that the corporation pay any tax on the income that gives rise to the dividend at all, and corporations that have losses that may be carried forward to reduce the taxable income or have income from foreign affiliates that is not subject to Canadian taxation may have an effective tax rate that is much lower than the notional rates used in the gross-up and credit system.[216]

With the above in mind, it is important to consider that pension plans have been turning more and more to the stock market, as described in numerous instances in this paper, which means that there are potentially more and more dividends being received by pension plans. Whether the pension plan invests as a pension trust or through one of the numerous tax-exempt investment corporations discussed earlier in this paper, the dividend treatment would normally be preserved and flowed-through to the ultimate beneficiary or shareholder, as the case may be, in the case of taxable entities. The flow-through in the first instance would be under the designation under subs. 104(19) of the ITA, which allows trusts to preserve the character of dividend income when paying it out to beneficiaries, allowing the beneficiary to take advantage of the dividend gross-up and credit regime. The second flow-through would be by virtue of the intercorporate dividend deduction in subs. 112(1) of the ITA, which allows dividends to flow tax-free between corporations, provided the receiving corporation holds a sufficient enough interest or controls the paying corporation.[217] This deduction ensures that when dividends are ultimately paid to the individual shareholder, the income has not been taxed beyond the initial receipt and integration is thereby preserved.

215. See s. 125 of the ITA.
216. Smart, *supra*, footnote 210, at p. 421.
217. See s. 186 of the ITA.

However, the character of dividend income is not preserved through the EET system and retirees that receive a pension payout do not get the benefit of the dividend gross-up and tax credit treatment. The loss of the dividend income character, accordingly, means integration is not promoted in the case of pension corporations and their beneficiaries, who are effectively put in place of shareholders that would otherwise receive the dividend income. As mentioned above, there is no requirement that the dividend-paying corporation pay any tax and the tax-exempt status of the pension corporation should therefore not be an impediment to allowing retirees to reap the benefit of the dividend tax credit. In a similar vein (and relating to the discussion on capital gains above), no capital dividend account is created for any pension investment corporations when they realize a capital gain on disposition of property and the tax-free capital dividends that would otherwise be paid out to a shareholder are not paid to retirees[218]. The pension trust also cannot preserve and flow-through the capital gains treatment, unlike most trusts under subsec. 104(20) of the ITA.

Finally, the lifetime capital gains deduction is another valuable tax attribute that should be considered. Introduced in 1985, the deduction was designed to give every Canadian resident individual[219] a cumulative lifetime exemption from capital gains taxation on the disposition of certain property. The policy behind the deduction was to provide a major incentive for individual investment in new and growing Canadian businesses,[220] which typically have difficulty accessing capital. The deduction was considered to be the most effective way to provide assistance to certain sectors of the economy (such as farming and fishing and small business generally), attract new equity investment and assist small businesses with raising much needed capital in order to pursue new ideas and directions through research and development.[221]

218. See ITA, s. 83 and the definition of "capital dividend account" in s. 89(1).

219. Under ITA, s. 110.6(5), certain non-residents that left Canada at a point in a particular taxation year are deemed to have been resident in Canada for the entire year, provided they were resident in Canada for the entire preceding year or are resident in Canada for the entire following year.

220. Canada, Department of Finance, *Technical Notes to Draft Amendments to the Income Tax Act and Related Statutes* (Ottawa: Department of Finance, 1987).

221. Canada, House of Commons, *Standing Committee on Finance and Economic Affairs*, *Report on the White Paper on Tax Reform (Stage 1)* (Ottawa: Queen's Printer, November 1987), at p. 47.

The intention was that this would lead to an increase in real investment in these sectors, with positive evidence that this was successful.[222]

Currently, the property that provides access to the deduction consists of certain farm or fishing property and shares of a "qualified small business corporation" ("QSBC" shares). A "small business corporation" is defined as a Canadian-controlled private corporation ("CCPC"), all or substantially all of the fair market value of the assets of which are attributable to assets are used principally in an active business carried on primarily in Canada, or shares or indebtedness of a connected "small business corporation".[223] In order to be QSBC shares, the shares in question also have to meet a series of holding and asset tests, such as not being owned by any unrelated parties and having at least 50% of the fair market value be attributable to assets used principally in an active business in the preceding 24 months, alongside certain other requirements.[224] The amount of the deduction is $800,000. It is annually indexed for inflation and is currently $866,912. The deduction cannot be used if the individual has certain types of tax losses in a particular taxation year, whether realized or carried forward, effectively forcing individuals to use any available losses first.

As described above, pension plan investment in alternative investments, which includes private equity, has been increasing. According to a recent report by Willis Towers Watson, alternative investments have risen from accounting for 4% of pension assets to approximately 20%, in the past 20-year period.[225] Certain larger public sector pension plans, such as the Ontario Municipal Employees Retirement System ("OMERS") have even created investment arms dedicated specifically to investing in growth-oriented start-up companies that focus on disruptive technology and growth in fields such as fintech,

222. Kenneth J. McKenzie and Aileen J. Thompson, "The Impact of the Capital Gains Exemption on Capital Markets" (1995), 21 Can. Pub. Policy 100, at p. 113.
223. Definition of "small business corporation" in ITA, s. 248(1).
224. Definition of "qualified small business corporation shares" in ITA, s. 110.6(1).
225. Willis Towers Watson, *Global Pension Assets Study, 2018* (London: Thinking Ahead Institute, February, 2018), online: <https://www.willistowerswatson.com/-/media/WTW/Images/Press/2018/01/Global-Pension-Asset-Study-2018-Japan.pdf>.

blockchain, artificial intelligence, health technology and machine learning.[226]

These are fields that are ripe for economic growth in a world increasingly focused on e-commerce, globalization and technology. They are also often smaller start-up businesses that require venture capital financing or angel investors, particularly if they are looking to eventually "exit", *i.e.*, go public or be acquired by a larger company. While start-ups are known to be risky, success stories such as that of Shopify are a motivating factor that inspires innovation and taking the risk in starting a small business in the tech world. Shopify was initially a small tech firm that exploded in its initial public offering and raised $131 million dollars with its stock 30 times oversubscribed.[227]

Among Shopify's major pre-IPO investors was OMERS Ventures, the OMERS investment arm dedicated to disruptive technology companies described above. Accordingly, not only are pension plans seemingly taking more and more chances on investing in private equity and smaller Canadian businesses that require funds for capital to invest in research and technological advancement, this seems to be a venture that can pay off in spades. Therefore, adding an extra incentive such as the benefits of a lifetime capital gains deduction that can be attributed or allocated to individual beneficiaries, would only go to further promote already existing tax policy behind the lifetime capital gains deduction and investment practices that are being pursued more and more by pension plans, encouraging both economic growth as well as pension plan sustainability. An added benefit would also be that the lifetime capital gains deduction would be provided to generally less wealthy individuals, *i.e.,* salaried employees, mitigating the concern that access to the capital gains deduction benefits primarily higher income individuals.[228]

Similar to capital gains and dividend treatment flow-through for beneficiaries of trusts, the lifetime capital gains exemption can be flowed out to beneficiaries by virtue of subsec. 104(21.2), whereby the individual beneficiary is deemed to have disposed of

---

226. See <https://www.omersventures.com/>.
227. Leslie Picker and Scott Deveau, "Shopify raises $131-million, pricing IPO above increased range", *The Globe and Mail* (May 20, 2015), online: <https://www.theglobeandmail.com/technology/tech-news/shopify-raises-131-million-pricing-ipo-above-increased-range/article24525737/>.
228. Canada, Department of Finance, "Tax Fairness for the Middle Class and Opportunity for All Canadians", *Backgrounder* (February 27, 2018).

the property that can be subject to the lifetime capital gains deduction. Accordingly, the lifetime capital gains deduction should also be considered as a beneficial tax attribute that can be flowed-through or attributed to pension plan retirees.

4.2 Allocating the Tax Attributes to Plan Members

The ability of a trust to effectively allocate the benefits of certain special types of income, such as dividends (including capital dividends), capital gains (including capital gains that are deductible under the lifetime capital gains deduction), and pension benefits, among others, is not the only instance where the beneficial character of certain income or other tax attributes are effectively flowed through an entity to provide access to such tax attributes or beneficial treatment to the ultimate or underlying beneficiaries or investors. Corporate integration, including the dividend gross-up and tax credit system and the capital dividend account, is another such example (as discussed above).

Another valuable example is the flow-through share ("FTS") regime for Canadian oil and gas, mining and renewable energy sectors. The majority of the FTS rules were introduced in 1986, and initially addressed only the oil and gas sector, later followed by numerous amendments and additions of other sectors.[229] The impetus behind these rules, similar to the lifetime capital gains deduction, was to encourage investment in certain sectors. However, a key difference is that the FTS rules effectively allow the investors in a particular company engaged in certain activities to claim the expenses made by the company in the course of such activities and deduct such expenses against their own income. As corporations are not generally flow-through entities (whereby their expenses cannot be claimed by shareholders)[230] and are subject to lower tax rates than, for example, individual investors taxed at top marginal tax rates, allowing certain corporations to flow-through their expenses to investors provides an attractive mechanism to raise funding as the deduction may be much more valuable in the hands of that investor than the corporation itself.[231]

229. Gregory M. Johnson and Wesley R. Novotny, "An Update on Flowthrough Shares in the Energy Sector," in *Report of Proceedings of the Sixty-Eighth Tax Conference*, 2016 Conference Report (Toronto: Canadian Tax Foundation, 2017), 12:1-39.

230. *Ibid.*, at p. 12:2.

231. *Ibid.*

The FTS regime entails an investor subscribing for FTS shares of a corporation under a contract, likely through a private placement or offering memorandum.[232] Pursuant to the subscription agreement, the company covenants to incur and renounce certain permitted expenditures, in an amount equal to the gross subscription proceeds. The investor pays the subscription amount and the company issues the FTS. The company then incurs the relevant expenditures and the tax deductions attributable to the relevant expenditures are shifted to the FTS holder, who is generally entitled to deduct the expenditures against their business income.[233]

Accordingly, the ITA has multiple instances where the benefits of special types of income or tax attributes realized by a particular business or investment entity can be flowed down or attributed to the individuals who will receive the ultimate benefits of the business activity, as well as incur the ultimate tax burden. This can be the case for pension plans and their beneficiaries as well, with respect to dividends, capital gains and the lifetime capital gains deduction.

The point of departure for pension plans to flow-through these attributes or benefits to retirees would be the current PA/PSPA/PAR system, which already provides the foundation for tax attributes to be accounted for individual members on an annual basis. As described earlier in this paper, the administrator is tasked with calculating and reporting the PA for each individual member. When there are changes to the benefit formula or active members transfer to another pension plan that provides better benefits or buy back service, a PSPA is created and also has to be calculated and reported. If a member terminates and receives a lump-sum payout, a PAR may also be created.

Accordingly, these three accounts handle the major components of an active member's "life cycle" as a contributing member of a pension plan: regular membership (PA), transfer between plans or change in entitlement to benefits (PSPA) and termination from a plan (PAR). As also described earlier, the maintenance and accurate reporting of these accounts requires constant and effective communication between employers and administrators. These three accounts and the administrative and reporting foundation created to support them then create a suitable vehicle through which to

232. *Ibid.*, at p. 12:6.
233. *Ibid.*

calculate and accrue the beneficial tax treatment associated with dividends, capital gains and the lifetime capital gains deduction to individual pension plan members.

Doing this would first require pension plans and their subsidiary investment entities to account for the amount of income that is earned through dispositions that would have otherwise been taxed on capital account, dispositions of any QSBC shares and the amounts of dividends received (and whether those dividends are eligible dividends, *i.e.,* dividends subject to a higher tax credit). Considering that pension plans currently do not even have to calculate their taxable income,[234] this appears to be a task that will require considerable further resources and time and this is addressed further below in the counter points to this suggestion. After accounting for the proportion of a pension plan's income (including the income of its tax-exempt investment subsidiaries) that is subject to the favourable tax treatment, the total amounts could be aggregated in order to create a whole picture of the plan's total annual income. The proportion of that income that would otherwise be subject to the favourable tax treatment could then be attributed to pension plan beneficiaries.

The specific means through which to attribute the benefits of favourable tax treatment on certain income varies and would depend on certain factors. One possible option would be to create notional accounts for each individual member through their active contribution cycle, whereby the character of the different types of income earned by a pension plan in any given year is effectively preserved and attributed to the pension plan beneficiary in that particular year alongside the associated favourable tax treatment, on a carry-forward basis. In other words, the proportion of a pension plan's income that is comprised of dividends it receives and capital gains it realizes (including on dispositions of QSBC shares) in any given year would be allocated pro-rata to the active members making contributions in that particular year. This would create notional accounts, say one for dividend income and one for capital gains that would then allow the active members to reduce their effective tax rates accordingly through the years in which they receive a pension pay out. Their pension income would be paid out of three separate accounts — a capital gains account that is taxed at a one half-inclusion rate, a proportion of which may be

234. Forman, *supra*, footnote 54, at p. 324.

completely tax-free by virtue of the lifetime capital gains deduction, a dividend account that would subject the income to the dividend gross-up and tax credit regime, and a regular income account that would subject their income to ordinary pension income taxation pursuant to subpara. 56(1)(a)(i), including the pension and age tax credits described earlier in this paper.

Some form of methodology would be required in order to appropriately apportion the different types of income to different notional accounts and aggregate it over the years. Merely relying on the percentages of a pension plan's total income for a year would not be sufficient for this purpose, as the amounts would either need to be monetized or aggregated without either duplication or failing to account for fluctuations in percentages over the years. This difficulty can be demonstrated using the example given at the very beginning of this paper, where a pension plan earns 50% of its income from dispositions of property on capital account. As discussed in the introduction, the pension plan would only pay tax on 75% of its income, due to half of the income being taxed at half the rates. If flowed through to a retiree in that very year, it would be relatively easy to flow through the benefit — half of the beneficiaries' income would be taxed at a full inclusion rate, the other half at half inclusion rates.

However, when considered over the course of a working career that may span decades, it becomes much more difficult to account for this. A plan may make 25% of its income from capital gains in a given year, but only 10% the next, and then 30% the year after. Simply adding the percentages does not work, and combined with the need to calculate three different notional accounts, it seems that what is necessary is to somehow monetize the amounts. One means to do this would be to consider and rely on the actual benefit accrued to any given individual member in a year. After all, defined benefit pension income isn't merely the income of the pension plan paid out but is rather based on a particular pension promise, the consideration for which is fulfilled every year through pensionable service and possible contributions by the active member. Accordingly, one possible means could be to rely on the currently used calculation of the pension promise for tax purposes, *i.e.*, the PA.

Recall that the PA is the amount by which a particular individual's RRSP contribution room is reduced in a given year.

While the calculation of a PA for a defined contribution plan is simple, being the amount of the contributions, defined benefit plans entail a more complex method (as described earlier in this paper). Recall also that the defined benefit "pension credit" depends on an individual's "normalized pension" for a given year, which is the amount of benefits that the individual would be entitled to if they were to retire at the end of that particular year. The amount determined under the "normalized pension" calculations (as described in detail earlier in this paper) is then multiplied by the factor of 9 and deducted a sum of $600, in order to create the PA.

Of course, the purpose of the PA is to reduce the RRSP contribution room in that given year on the same basis as if the benefits accrued were a lump sum contribution to a defined contribution plan. Accordingly, taking the individual's PA for a given year and multiplying it by the varying percentages of the different types of income in that given year may not form an appropriate basis for the notional accounts that create an overall annual entitlement at retirement. To use the example mentioned earlier in this paper, suppose an individual has a defined benefit plan that provides pension benefits based on 2% x Years of Service x Career Average Earnings. They earn $50,000 in a particular year. The benefit entitlement or "normalized pension" for the year would be 2% x $50,000, which is $1,000. The PA would therefore be ($1,000 x 9) - $600 = $8,400. Using a simplified example, suppose the pension plan's income that particular year consisted of 40% interest income, 20% capital gains and 40% dividend income. Accordingly, a total amount of $3,360 would be contributed to the dividend income account, a further $3,360 to the regular income account and $1,680 to the capital gains account (a portion of which could further be designated as subject to the lifetime capital gains deduction).

While the above seems reasonable at first glance, simply accumulating the notional accounts in such a manner would not work, as the accounts would quickly become bigger than the actual pension promise. To use the above example, suppose the individual continues to earn the same amount of income subject to the same pension formula for 10 years, with the pension plan accordingly earning the same percentages from capital gains and dividends. After 10 years, the dividend and regular income pension accounts would each be $33,600 and the capital gains pension account, $16,800, making for a total annual amount of

$84,000. The individual's annual pension entitlement under the defined benefit formula, however, would only be $10,000.

The solution then, would be to use the "normalized pension" amount, *i.e.*, without the factor of 9 and the PA offset. Using the same example above, after 10 years, the dividend and regular income account would each be $4,000 and the capital gains account would be $2,000. The individual's pension annual entitlement would remain $10,000. Accordingly, the individual's annual pension entitlement would be proportionately split into the different types of earnings earned by the pension fund during the individual's years of service. Of course, this calculation is based on a very simple normalized pension calculation and as discussed earlier in this paper that is often not the case. An exploration of the various complexities that could arise in this method for normalized pension calculations that vary based on formulas that provide for different percentages depending on whether earnings are less or more than the YMPE, flat benefits with negotiated increases, and caps on pensionable earnings (to name a few) is beyond the scope of this paper and it would remain to be seen whether the approach would work in those instances.

The notional account system could further piggyback on the PSPA and PAR mechanisms, where members transferring between pension plans would bring over their notional pension income accounts and rely on the PSPA calculation for any potential additions. Recall that the PSPA effectively reduces RRSP room based on the net between the PAs that should've been reported were the higher benefits in place at the time, and the PAs that were actually reported, alongside certain other adjustments. As described earlier in this paper, the basic PSPA approach is generally used where previous benefits are improved and past service is bought back and the modified PSPA approach is generally used when there has been a transfer of benefits pursuant to a reciprocal transfer or portability. In either case, as a PSPA means a higher amount of accrued benefits, there would be an addition to the notional accounts if one arises.

If a PSPA arises, one could calculate the excess normalized pension amount by having the PA offset added back and then dividing the amount by 9 to effectively step back to the original starting calculation that would have formed the basis for the extra PA. This amount represents the extra benefits earned and accordingly would be added to the notional accounts. It would be a matter of policy whether to base the percentages for the allocation to the notional accounts on the capital gains and dividend earnings of the receiving plan or the transferring plan in the years in question. As the member is effectively receiving the benefit of pensionable service as if they had been with the receiving plan the entire time, it would presumably make more sense to base the allocation to the notional accounts based on the percentages of the receiving pension plan, rather than the transferring one.

Finally, recall that in the event of a plan member's termination, whether in the case of leaving employment, plan wind-up or certain other instances (as discussed in detail earlier in this paper), a PAR may be created. Recall again that a PAR usually accounts for the overstatement of benefits by the PA and is generally calculated by taking the aggregate amount of an individual's PAs and PSPAs over the years of service and netting the amount of the lump sum payment, increasing RRSP room accordingly. While the PA overstatement of benefits is not an issue in the case of the proposed notional accounts, as the factor of 9 is not used to determine them, the PAR mechanism would generally not affect the calculation of the proposed notional accounts when a lump sum amount is paid out to a member or is transferred to their RRSP or a defined contribution plan. In these cases, it would also be a question of policy of whether to carry through the notional accounts to the RRSP or defined contribution plan and whether to split the taxation of the lump sum received directly in accordance with the proportions of the notional accounts. This paper considers the use of the notional accounts specifically as a means to reduce the effective tax rates of retirees of defined benefit pension plans, and accordingly, this question is beyond its scope.

However, recall also that a PAR may arise in a reciprocal transfer or portability arrangement situation, where the benefits of the receiving plan are less generous than the transferring plan. As described earlier in this paper, element D in the PAR formula is effectively the lesser of the PA value of the past service benefits under the importing plan and the PA value of the benefits under the exporting plan, and will usually only be positive if the importing plan provides less generous benefits, thereby resulting in a PAR of the amount of the difference. As this amount is also based on the PA amounts, adding back the PA offset and dividing it by 9 will return the amount to the pre-

PA “normalized pension” amount. As the member now effectively has less benefits accrued under the pension plan, the notional accounts will be reduced by this amount in accordance with the percentages of the receiving plan (as per the discussion on this point in the PSPA addition to the notional accounts, above).

Accordingly, the creation of notional accounts and the reliance on the current normalized pension calculation and the PA/PSPA/PAR mechanisms in order to fund them throughout not only an active member’s contribution period, but in cases of benefit increases and transfers between plans, appears to be one feasible manner in which to account for the different types of pension income and the associated beneficial tax treatment. One could also consider two other alternatives. The first alternative would entail calculating which percentages of a pension plan’s annual earnings are attributable to dividends and capital gains, as above, but then paying out the current retirees their pro rata shares of their annual pension in proportion to the plan’s earnings from capital gains (including capital gains that are deductible under the lifetime capital gains deduction) and dividends in that very year. This approach would eliminate the complexity of creating notional carry forward accounts.

However, unlike the OAS, Canadian defined benefit pension plans are not structured on a “pay-as-you-go” basis, where the annual contributions of a pension plan are used to fund retiree benefits in that very same year and active workers merely receiving a promise of future benefits (that inevitably relies on future contributions by active members). Rather, defined benefit plans operate on a funded basis, whereby an active member’s contributions are pooled in a fund that accumulates earnings and then pays out the pension promise with the earnings made from the contributions. If current contributions are used to fund retiree benefits at the very same time in a funded plan, questions of intergenerational equity will inevitably arise with younger members effectively being responsible for the retired members. Similarly, it may not appear to be equitable to have the earnings of a fund in a particular year give the tax attribute benefits to retirees that did not contribute in that particular year. Accordingly, it would make more sense to have the retirees receive the benefit of tax attributes of earnings in the years in which the retirees were active members and this alternative may therefore not be as feasible as the notional accounts option discussed above.

The other possible alternative would be to simplify things even further and create an enhanced pension credit. In order to do this, certain assumptions would need to be used, such as the average percentage of a pension plan's earnings that are made through capital gains and the receipt of dividends and an amount that could possibly approximate the benefit of these attributes on a pro rata basis would be added to the pension credit. This would, of course, be a very rough measure of the tax benefits associated with dividend and capital gains income and the lifetime capital gains exemption but would certainly bring about a considerably lower administrative burden than the two other alternatives mentioned above. However, as stated above, "equity requires measurement"[235] and this approach would certainly lack the requisite precision.

Regardless of which option is pursued, accounting for the lost tax attributes and providing retirees with a reduced effective tax rate as a result would have numerous beneficial impacts. First and foremost, of course, is the impact of a higher after-tax income for retirees. This would not only be beneficial to the retirees themselves through allowing a higher level of retirement income and therefore better standard of living, but would have a beneficial impact on the economy as well. Retirees that have defined benefit pensions are a valuable economic force in Canada and spend approximately $60 billion annually on consumer goods and services and real estate, in addition to expenditures on sales and real estate taxes.[236] They are also more self-sufficient, whereby only a fifth are eligible for the federal GIS supplement, as compared to 40% of retirees without defined benefit plans.[237] This means less government (and therefore taxpayer) money needs to be spent to provide assistance to this particular cohort.

Another benefit would be the economic trickle-down effect that may span all the way back to the original contribution levels, which may be reduced as a result of a higher after-tax income being received by retirees.[238] This could also mean a lower initial pension promise and thereby lesser funding requirements for employers to keep up with (although, understandably, this benefit may offset part of the first-

235. Towers Watson, *Canadian Pensions and Retirement Income Planning*, *supra*, footnote 106.
236. Leech and McNish, *supra*, footnote 7, at p. 154.
237. *Ibid.*, at p. 154.
238. Jog and Mintz, *supra*, footnote 163, at p. 583.

mentioned benefit of higher income during retirement). Reduced contribution levels would also mean more government tax revenue as there are lower deductions against income being taken at the contribution stage, where the income (and therefore the tax rates, at least for individuals) also tends to be higher.

Finally, creating an incentive to direct pension plan investment towards smaller Canadian businesses, so as to allow for the use of the lifetime capital gains deduction on a portion of the capital gains notional account, will provide salaried employee retirees with an opportunity to use the deduction that they otherwise would not have had. As stated above, the lifetime capital gains deduction is generally used by wealthier individuals that own the businesses being sold, and given that the shares of CCPCs are usually closely held by related individuals, it is unlikely that salaried employees would have much opportunity to otherwise invest in such businesses and thereby be able to use the lifetime capital gains deduction. Conversely, this incentive to invest in more small Canadian businesses, that otherwise have trouble accessing capital with which to fund technological research and development, would mean more pension plans would take the role as angel investors and provide venture capital to Canadian start ups and small business which can then achieve economic and technological growth and thereby contribute to the Canadian economy and technological advancement.

Overall then, it appears that accounting for the beneficial tax attributes in the hands of retirees has some worthwhile benefits as it may not only assist retirees have higher after-tax income and therefore a higher quality of life, but also reduce the funding burden and contribution levels for sponsoring employers and encourage economic development through pension plan investment in small Canadian business. Of course, the benefits are not without their pitfalls and certain issues may arise in proceeding with the notional accounts plan, whether through the implementation aspect, the existence of an actual economic advantage or policy concerns. These issues are addressed next in this paper.

4.3 Potential Issues and Counterarguments

The implementation of the notional accounts system has potential benefits, as described above. However, due to the technical nature of the approach and the tax-exempt status that provides the context, it is not without potential problems. Further, the fact that it provides a benefit to a cohort that is already perceived as advantaged, it is not without its flaws policy wise. Before any concrete decisions are taken with respect to the approach, these issues need to be addressed.

The Administrative Costs

Canadian pension plan administrative costs are among the highest in the world, alongside the United States.[239] Introducing a complex new methodology in the form of the proposed notional accounts described above to an already fragmented regulatory environment model that is simultaneously struggling with increasing complexity due to changing investment platforms,[240] may seem like a costly option that may simply not be feasible, given the requisite time and expense that compliance would take. In addition, aside from introducing a set of new notional accounts to consider, pension plans will now no longer be neutral as to the tax treatment of their income, introducing a measure of tax planning into the mix. This means costly legal and accounting advice and a further element to consider in designing and implementing an investment mandate.

Additionally, the complexity of the PA/PSPA/PAR regime alone appears to be quite Byzantine and beyond the comprehension of the average employer and employee alike, leaving it to pension experts to handle the implementation, administration and maintenance of pension plans.[241] This inevitably makes it difficult for most Canadians to understand how their retirement savings work. Accordingly, where retirees previously received only one payment and claimed one tax credit, they would now have three different accounts with different tax treatment for each and the additional consideration of the lifetime capital gains deduction. This would presumably impose considerable further administrative costs on the pension plan in advising and explaining the new system to retirees and active members alike.

---

239. Jacob A. Bikker, O.W. Steenbeek and F. Torracchi, "The Impact of Scale, Complexity, and Service Quality on the Administrative Costs of Pension Funds: A Cross-Country Comparison" (2012), 79 J. Risk Insur. 477, at p. 485.

240. World Bank, *The Evolution of the Canadian Pension Model*, *supra*, footnote 193, at p. 69.

241. Pierlot, *supra*, footnote 108, at p. 5.

However, the issues above may not have as much of an impact as initially seems.

Firstly, the administrative costs of member presentations and one-on-one counseling comprise approximately half a percent of the total administrative costs of a pension plan,[242] with the management of major capital projects, transfers in or buy-ins, and pension inception being the most costly.[243] While the proposed notional accounts concern the transfers in or buy-ins element, as described above, the idea would be to take advantage of the existing PA/PSPA/PAR system and therefore, the additional administrative costs would be mitigated by this factor. Note also that the costs of rule interpretation are also quite minimal, comprising a mere 3% of the total administrative costs.[244]

With respect to introducing a costly tax planning element into the pension plan administration, the erroneous assumption is that this element does not already exist because pension plans are exempt entities. This is far from true, and in fact, pension plans often engage in various tax planning techniques in order to utilize their tax-exempt status to their advantage. One particular example comes to mind where pension plans circumvent the 30% rule in Schedule III (as described earlier in this paper) by purchasing convertible debentures that can then be rolled into voting or non-voting shares or appointing a nominee on a corporate board,[245] thereby achieving effective control of a corporation.

Once this is done, two structures enable pension funds to reduce the payment of corporate income tax as an example. The first arises when the pension fund substitutes equity for debt provided by the pension fund, allowing the corporation to deduct interest where the pension fund does not have to pay tax on the resulting interest income. Alternatively, a partnership can be established whereby the partnership's income is flowed to the pension plan (as the partner) and is not subject to tax, enabling the pension fund to eliminate or substantially reduce corporate tax paid by the operating entity.[246] This tax advantage effectively allows pension-controlled businesses to operate at a competitive advantage as compared with taxable businesses, due

242. Bikker, Steenbeek and Torracchi, *supra*, footnote 239, at p. 512, Table C.2.
243. *Ibid.*
244. *Ibid.*, Table C.2.
245. Jog and Mintz, *supra*, footnote 163, at p. 575.
246. *Ibid.*

to the lower tax cost. This form of arbitrage also provides pension funds with an important advantage in acquiring companies, potentially being able to outbid taxable investors.[247] Accordingly, pension funds can, and do, engage in sophisticated tax-planning techniques and while introducing further considerations would certainly add to the expense, this would at least be mitigated by the fact that there is already an established framework of legal and accounting advisors that would be able to handle the extra workload.

Finally, while the administrative costs component is an important one to consider, it should also be considered in the broader context of the Canadian pension landscape. Canadian pension plans have considerable economies of scale, which are currently growing (at least for the bigger public sector pension plans)[248] and enable the reduction of administrative costs. There is also a trend towards fragmentation for pension plans outside of the major public sector plans, which, conversely, increases administrative costs by as much as double the cost.[249] Accordingly, if we are to concern ourselves with administrative costs, the solution should be sought out in centralizing and unifying the pension plan system to reduce the aforementioned fragmentation, rather than dismissing potentially valuable changes that can assist retirees and employers alike.

Tax-Deferral Benefits

In discussing the issues that arise due to the tax-exempt status of a pension plan and its various investment entities, *i.e.*, the loss of beneficial tax treatment of dividends and capital gains, one cannot ignore the obvious benefit of the tax-exempt status for the retirees: significant tax deferral. The pensioners, while not getting the benefit of the aforementioned tax attributes, effectively receive years and possibly decades of tax deferral. This is not an advantage that can be easily overlooked.

Tax deferral is an incredibly valuable element. Nobel laureate Merton Miller put it well when he said that "by conventional folk wisdom, 10 years of tax deferral is almost as good as exemption."[250] Shifting the timing of income recognition

247. Jog and Mintz, *supra*, footnote 163, at p. 575.
248. World Bank, *The Evolution of the Canadian Pension Model*, *supra*, footnote 193, at p. 68.
249. Leech and McNish, *supra*, footnote 7, at p. 155.
250. Merton H. Miller, "Debt and Taxes" (1977), 32 J. Fin. 261, p. 270, cited in Graham Purse and Jeff Hansen, "A Review of the Specified Corporate

through tax deferral can also be thought of as an "interest-free loan" from the government.[251] It also provides the additional benefit of time value of money, whereby funds not paid in tax can be invested to earn a return, where for example, a tax deferral of $57,500 at an annual rate of return of 3% would grow to $103,851.40 after 20 years.[252]

Tax deferral is also tantamount to not paying tax on the earnings on your capital and, when tax deferred funds are invested (such as in a pension plan or RRSP account), the growth in the fund is much larger than it would have been had the earnings been taxable.[253] Further, as the funds are paid out much later when other sources of income may be reduced, the value of tax deferral also presents itself in providing a larger deduction (at a time when income is higher and therefore taxed at higher rates) when compared to the timing of the inclusion.[254] Finally, an added benefit may be that the law may change in the taxpayer's favour when the income inclusion is finally faced, for example where marginal tax rates are reduced or a higher tax credit relevant to the income in question is provided.[255]

Accordingly, the question in this case is whether the tax deferral for a pension plan already provides a higher benefit in terms of total tax payable than the ability to use the capital gains inclusion rate and dividend tax credit. The answer to that question is, it depends. Alex S. MacNevin considers this point in his study on comparative tax advantages of pension funds when investing in real estate,[256] stating that "whether or not the tax deferral provides a net advantage in comparison with the advantages of the lost corporate-personal tax integration and the partial taxation of capital gains depends on the length of the deferral period."[257] Based on the assumptions used in the study, he finds that the tax deferral does in fact provide a higher benefit, stating the following:

> While the corporate taxes paid by taxable and tax-assisted investors are

---

Income and Specified Partnership Income Rules and their Application", in *2018 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2018), 10:1-19, at p. 4.

251. Purse and Hansen, *ibid*., p. 4.
252. *Ibid*.
253. Hogg, Magee, and Li, *supra*, footnote 207, at p. 29.
254. *Ibid*.
255. *Ibid*., at p. 29.
256. Alex S. MacNevin, "Comparative Tax Advantages of Canadian Pension Funds as Investors in Real Estate" (2013), 61 Can. Tax J. 41, pp. 41-78.
257. *Ibid*., at p. 46.

> the same, the net present value of the personal tax payable on the earnings when they are paid out of the savings or pension plan (at a discounted effective rate of 16.1 percent over a 26.5-year shelter period) is considerably lower than the tax rate on dividends under the DTC mechanism for a taxable investor (28.2 percent). It is also lower than the AETR that applies to capital gains for taxable investors (22.8 percent).
>
> . . . . .
>
> Thus, *the tax-deferral advantage of pension funds and registered savings plans more than offsets the advantages that derive to a taxable investor, by way of the favourable treatment accorded to dividends through the DTC and to capital gains through the 50 percent inclusion rate and the deferral of tax until realization.* [Emphasis added]

This would appear to defeat the purpose of the proposed allocation of the dividend tax credit and capital gains inclusion rate benefits to retirees. However, MacNevin's study is based on certain assumptions, including the amount of total income that income from capital gains comprises, whereby increasing the proportion of income that is capital gains beyond a certain level was actually found to create a disadvantage in the comparative returns.[258] Further, MacNevin also does not factor in the potential benefits of the lifetime capital gains deduction.

Finally, the key difference is that MacNevin's study is based on, and the tax-deferral counterpoint presumes, an either-or reality. That is to say, MacNevin is making a comparison between taxable and tax-exempt entities and the tax-deferral counterpoint is based on which measure provides higher value. The question in this paper is not, however, how to better provide value to retirees through the income tax system but rather how to use the income tax system overall to assist retirees and therefore pension plans.

Accordingly, the question to ask isn't whether tax deferral is better than allocating the benefits of the dividend tax credit, capital gains inclusion rate and the lifetime capital gains deduction to retirees. It is whether to provide the latter benefits *in addition* to the tax deferral. And that question is better addressed in the next and final counterpoint, which considers the question of whether providing the retirees of defined benefit pension plans with further tax advantages is equitable as a matter of policy.

---

258. *Ibid.*, at p. 74.

The Haves and Have-Nots

The 1989 federal government proposals that culminated in the 1991 Pension Reform described the then-current pension system as unfair, inequitable and "seriously flawed".[259] The reasons given were numerous, among them the fact that different types of tax-assisted retirement plans had different contribution limits (for example defined contribution plans versus defined benefit plans), the system allowed for opportunities of abuse and excesses by high-income earners,[260] and that those who did not have access to better tax-assisted savings vehicles, such as defined benefit pension plans, were considerably worse off when left only with access to tax-assisted savings by means of an RRSP.[261]

The mass of highly technical and wide-spanning changes that were introduced under the above proposals, and now comprise the current pension taxation regime in the ITA, are thereby built on the principle of equity between the "haves" and the "have-nots", as mentioned throughout numerous points in this paper. The PA, PSPA and PAR are all meant to ensure that those with a pension plan, particularly with a defined benefit pension plan, are not worse off than those with merely a defined contribution plan or an RRSP.

Even with these rules in effect, there is growing criticism (and sometimes even bitter sentiment) against those with defined benefit pension plans, particularly those in the public sector. Authors have critiqued the fact that public sector pension plans are effectively assisted by taxpayers, as it is the taxpayers who bear the ultimate risk of any shortfall in funding,[262] where James Pierlot aptly states:[263]

> . . . the risk of making good on DB pension promises is underwritten by public sector employers who, with access to tax revenue, have practically bottomless pockets. The pockets of private sector employers do have a bottom . . .

Further critique points out that the factor of 9 effectively still

259. Canada, Department of Finance, "Pension Reform: Improvements in Tax Assistance for Retirement Saving" (Ottawa: Department of Finance, 1989), at p. 1.
260. *Ibid.*, at p. 8.
261. *Ibid.*, at p. 9.
262. Shoven and Sialm, *supra*, footnote 53, at p. 21; and Pierlot, *supra*, footnote 108, at p. 15.
263. Pierlot, *ibid.*, at p. 15.

favours defined benefit pension plans as it understates the real cost of providing defined benefit, which costs substantially exceed defined contribution and RRSP contributions limits, and that there is also no direct limits on defined benefit plan contributions.[264]

With the major components of the current pension taxation regime based on equity between the pension "haves" and "have-nots", and substantial critique pointing out that there are other inequalities yet, how does one justify adding yet another benefit for the "haves", *i.e.,* the defined benefit pension plan retirees? The Canadian third pillar really seems to have been a story of "winners" and "losers",[265] so why give more to the "winners" and leave the "losers" stranded?

The answer to that comes in a Russian folk tale, as cited by Jim Leech and Jacquie McNish in their book titled "The Third Rail: Confronting Our Pension Failures".[266] The story goes that a farmer distraught over the loss of his most productive cow goes fishing, and catches a magic fish. The fish offers anything the farmer wants in exchange for the fish's life. The farmer then thinks about it, and asks for his neighbour's cow to die as well.[267] The moral is, of course, that it is absurd to solve a problem of inequality by simply taking away from the one with more.

Even those that critique the current state of pension plans and pension inequality certainly don't advocate for this approach, instead discussing ways to provide more to the "have-nots" with more, rather than simply arguing to not give anything (or take something away) from the "haves". Pierlot points out that the Canadian pension taxation regime is too rigid and in many ways simply disallows private sector pension plans to form large multi-employer pension plans that have the economies of scale, risk pooling and robust governance and oversight that are enjoyed by the large scale public sector defined benefit pension plans.[268] He suggests we abolish certain restrictive requirements that effectively prevent the formation of large scale pension plans for smaller private sector employers.[269] Horner suggests expansion of the CPP and QPP, a special tax

264. *Ibid.*, at p. 4.
265. *Ibid.*
266. Leech and McNish, *supra*, footnote 7.
267. *Ibid.*, at pp. 135-136.
268. Pierlot, *supra*, footnote 108, at p. 2.
269. *Ibid.*, at p. 20.

for RRSP contributions and support for employers that wish to start registered pension plans through grants or tax credits, among other incentives.[270] Other efforts have been to introduce mandatory pension plans such as the now-defunct Ontario Retirement Pension Plan, expand the CPP, explore ways to offer the benefits of public pension plans to more people (such as by expanding membership eligibility to part-time workers), offer third-party asset management services and develop alternative plan designs that let different types of workers join the plan.[271]

Accordingly, while introducing another benefit for defined benefit pension plans may cause an initial stir, the solution is not to forego the benefit, but rather to find ways to ensure that more Canadians get access to it. That means creating ways to encourage defined benefit pension plans again. After all, defined benefit pension plans are the most secure retirement savings vehicle, and when pooled together in larger funds, create a market force that benefits greatly from the sharing of savings through the aforementioned economies of scale. The advantages of these large scale defined benefit plans are also investment efficiency and expertise and much lower operating costs.[272] They are, hands down, the best option to pursue if we are going to have a secure retiree population.

And while it may be costly to provide tax incentives and credits, whether to implement the notional accounts system discussed herein or provide grants or tax credits to employers to start pension plans and numerous other tax incentives, the key thing to remember is that if we don't make these expenditures, the taxpayers will inevitably pay the price regardless, through the cost of OAS and GIS — currently already the highest national fiscal expense.[273]

5. Conclusion

Canada's colourful and eventful pension story has come to a unique and interesting point. The legal and regulatory regime, including the taxation rules, is highly developed and technical, with sophisticated mechanisms set in place to protect workers

270. Keith Horner, "Approaches to Strengthening Canada's Retirement Income System" (2009), 57 Can. Tax J. 419, at pp. 452-454.
271. World Bank, *The Evolution of the Canadian Pension Model*, *supra*, footnote 193, at p. 68.
272. Leech and McNish, *supra*, footnote 7, at pp. 155.
273. Leech and McNish, *supra*, footnote 7, at p. 146.

from employer whims, ensure prudent investment practices and treat those that have pension plans equally with those who do not, at least with respect to the amount of tax-assisted savings that can be accessed. Large defined benefit pension plans, at least in the public sector, are receiving world wide praise for their governance practices, use of economies of scale, and investment mandates[274] and serving as an exemplary model for other countries to follow. We have a well functioning safety net in the form of the CPP, OAS and GIS, should the pension plans and other registered retirement savings vehicles, such as RRSPs, fail to bring seniors to an income level high enough to support them. In other words, in many respects, we have done well.

In other respects, however, we have failed considerably. The means to provide equity (tax-wise) between the "haves and "have-nots" have not been enough, and the factor of 9 continues to favour defined benefit pension plan members over those with defined contribution plans and RRSPs. The rules are complicated and difficult to navigate, with the average Canadian unlikely to be able to comprehend their operation, never mind contemplating sponsoring a pension plan as a small to mid-level business. In that aspect, the funding difficulties of rigid rules and economic shocks (without an appropriate cushion to absorb them when the time came) have brought defined benefit pension plan participation to a state of an all-time low, where only approximately 10% of private sector employees have access to a defined benefit pension plan.[275] Business now considers defined benefit pension plans a liability that isn't worth the risk anymore and more and more employers are switching to defined contribution plans or group RRSPs or freezing defined benefit plan participation.[276] And the trend is only headed further downwards in these respects.

But we've taken notice. And we are exploring the problems in detail and starting to come up with solutions. The gradual expansion of the CPP has began. We are thinking about the need for more resilient funding methods that allow for absorption of economic shocks, such that when the inevitable "rainy day" comes, there is enough in the piggy bank to at least get an umbrella. The example of New Brunswick's target benefit pension plans is one such success story.

274. World Bank, *The Evolution of the Canadian Pension Model*, *supra*, footnote 193.
275. Hamilton and Cross, *supra*, footnote 51, at p. 1.
276. Pierlot, *supra*, footnote 108, at p. 6.

We are also discussing the problem of fragmentation into smaller, less secure plans that have less access to economies of scale by means of which to reduce investment and administrative costs and access better investment portfolio management. We are thinking about pooled registered pension plans, ways to alleviate barriers for employers to form large scale multi-employer defined benefit plans,[277] and realizing more and more that we need to keep the defined benefit pension plan around.[278]

And we need to start thinking more about the pension plan taxation regime. Some authors have begun to take notice and suggest changes from the tax point of view,[279] and this trend needs to continue. After all, given that so many provisions in the ITA are consistently reviewed, consulted on with the public and amended (sometimes on a pretty substantive basis), it is surprising we have not looked at the basic elements of the pension plan taxation regime in detail and said "how can we change these rules to assist the survival of defined benefit pension plans?".

That is what this paper set out to do. The pension taxation regime, as shown here, is extensive and technical, with very prescriptive requirements for all aspects of a pension plan and the accompanying member's life. It dictates everything from the parameters of registration and establishment, to the deduction at the contribution stage, to the various tax-exempt entities that may be used to earn investment income, to the payout stage. Within that, the highly technical PA/PSPA/PAR system, exists to ensure a simple purpose — that those with access to pension plans, whether defend benefit or defined contribution, do not get an extra benefit over those with only access to a RRSP. That system is built on principles of equity, and while certainly imperfect in a lot of ways (as discussed in numerous instances above), it does present a sound foundation to build on. And, as change to any system must be gradual and based on established principles and mechanisms, the notional accounts system through which further tax savings can be passed on to retirees is a great place to start.

Introducing the notional accounts system will simply put more money into the pockets of retirees and, indirectly the taxpayers, who would end up footing the bill anyways through

277. Pierlot, *supra*, footnote 108.

278. Leech and McNish, *supra*, footnote 7, at p. 162.

279. *Ibid.*; see Pierlot, *supra*, footnote 108, and Horner, *supra*, footnote 270.

OAS and GIS payments.[280] The retirees will, as a result, have more money to inject into the economy as a result and thereby continue to contribute to the societal mechanisms that keep things revolving. Simultaneously, the contribution levels and pension promises by employers may be reduced as well, meaning potentially lesser funding liabilities from employers and more survival of defined benefit pension plans.

And, while the proposed system will certainly introduce further complexity into an already costly administrative regime, and may certainly go against the basic principle of equity between the "haves" and "have-nots" by introducing an extra benefit to the "haves" (in addition to the tax-deferral benefit), the point should not be to detract from the success and abundance from the "haves". Rather, it should be to encourage access to the best retirement savings vehicle; the defined benefit pension plan.

And this isn't done through the tax system alone. It requires cooperation, communication, study, innovation and, most importantly, the will to solve things and keep the defined benefit pension plan alive by all the stakeholders. Government needs to begin to take more active steps to assist the survival of pension plans by re-evaluating the current rules and consulting with pension and tax experts, economists, actuaries, employers and union members. Strengthening regulation and making it more uniform and consistent in its various aspects needs to happen,[281] and regulators need to get on board with a collaborative approach with sponsors and administrators. Employers and administrators need to pay more attention to their funding levels and work together to advocate for changes to the rules that will allow them to band together in bigger plans that can reduce their administrative and investment costs and strengthen their place in the financial marketplace. Labour leaders also need to create reasonable pension expectations[282] and listen to financial experts when they tell them that the current model has its pitfalls and there may need to be flexibility in benefit and contribution levels in order to keep the plans viable.

In other words, we all need to chip in and work on this together. The notional accounts system is all but one small

280. Leech and McNish, *supra*, footnote 7, at p. 147.
281. World Bank, *The Evolution of the Canadian Pension Model*, *supra*, footnote 193, at p. 69.
282. Leech and McNish, *supra*, footnote 7, at p. 156.

brick, in a building that needs considerable restoration. The third pillar is wearing thin and the pressure is on, with more and more retirees and less and less retirement security. This certainly won't be the solution all on its own. But as part of a much larger repertoire, it can help reverse the downfall of the defined benefit pension plan and help many more Canadians retire with the requisite income security, so critically needed in those latter years after exit from the workforce.