Pension Law in Canada

January 2004

Pension Law in Canada - An Introduction for U.S. Clients

The establishment of a pension plan is not mandatory for employers in Canada. However, most large employers consider some form of pension or retirement plan to be a necessary feature of a competitive compensation package. As a result, there are approximately 14,000 employer-sponsored pension plans in Canada, covering just under 5.5 million employees or 40% of the total Canadian workforce.

Before an employer implements a pension plan for its Canadian employees, careful thought must be given to which type and structure best suits the employer's objectives, keeping in mind the administrative complexities involved. Pension plans in Canada are subject to significant regulation by pension and tax authorities and ongoing compliance with the applicable regulatory standards can be onerous and expensive for pension plan sponsors. Consequently, employers should seek professional advice before establishing a Canadian pension plan.

Legislative Framework

Pension Standards Legislation

Every jurisdiction in Canada, except the province of Prince Edward Island, has pension standards legislation that establishes minimum requirements for pension plans. In general, such laws are much less comprehensive than ERISA in the United States. The legislative and regulatory scheme governing Canadian pension plans is administered in each province by government pension commissions. For example, in Ontario, the *Pension Benefits Act* (PBA) governs pension plans registered in the province and the provincial regulator is the Financial Services Commission of Ontario (FSCO).

A reciprocal agreement among the Canadian provinces benefits employers with pension plan members in more than one province by only requiring that they register their plan in the province in which the majority of members are employed. However, such plans must still comply with the pension benefits legislation of each province in which plan members are employed.

The high costs of pension administration in Canada are partly due to the fact that pension plans can be governed by as many as nine different pension statutes. For years, the Canadian pension industry has been lobbying for simplicity and harmonization in the regulation of multi-jurisdictional pension plans, but the provincial governments have failed to make any meaningful progress on the issue.

Each of the provincial pension statutes imposes minimum standards on employers who sponsor pension plans. Specifically, the rules cover eligibility for membership, funding, disclosure to plan members, investment of plan assets, registration of pension plans, locking-in of contributions and benefits, vesting, business sales and corporate reorganizations, division of benefits on spousal relationship breakdown, and the form of benefits for members' spouses.

Employers are required to prepare a statement of investment policies and procedures (SIP&P) that sets out how a pension plan's assets are to be invested. A SIP&P must comply with the statutory investment rules. If good investment returns lead to surplus assets in an ongoing plan, pension legislation generally permits an employer to use the surplus to meet its contribution obligations, subject to the terms of the particular plan. In addition, where the plan documents and governing pension legislation permit, surplus assets that exist on the full termination of the plan may be returned to the employer. In most jurisdictions, some form of surplus sharing arrangement with the plan members is usually necessary for employer surplus recovery.

Income Tax Legislation

Canadian pension plans must also be registered under the *Income Tax Act* (Canada) (ITA). The rules and regulations under the ITA relating to registered pension plans are extremely complicated. Although the actual sections outlining the ITA's treatment of pension benefits are not numerous, thousands of pages of technical notes, newsletters, technical interpretations and budget speeches have been released regarding these provisions. The responsibilities imposed on pension plan sponsors are onerous, especially for those who sponsor defined benefit plans. The difficulty of compliance increases with plan complexity. Therefore, a fair degree of expertise is needed to comply with all aspects of the legislation.

Employer contributions to a pension plan are tax deductible and are only taxable to the member once he or she begins to draw a pension. Any investment gains earned on the contributions to the pension plan are generally tax exempt. Employee contributions, if permitted by the plan, are deductible to the employee in the year that they are made. This serves as an incentive to employees to contribute to their own pension plans.

Pension Funding

A pension plan registered under the ITA with the Canada Customs and Revenue Agency (CCRA) and the applicable pension regulatory authority must be funded in accordance with pension standards legislation and the ITA, its regulations and CCRA policies.

Minimum Funding Requirements

The regulations under pension legislation set out minimum funding requirements for pension plans. These requirements provide a level of protection for pension benefits through minimum funding levels and deadlines for contributions to pension funds. The minimum funding requirements apply primarily to defined benefit pension plans. The only requirements that affect defined contribution pension plans are those dealing with the timing of contributions.

Employers are required to contribute towards the current service costs of their pension plans. They are also obligated to make special payments over a specified period of time to amortize any unfunded liability or deficit that may exist. These amortization periods range from five to fifteen years, depending on the type of unfunded liability or deficit.

Pension Benefits Guarantee Fund – Ontario

Ontario is the only jurisdiction in Canada that provides a guarantee fund to protect pension benefits in the event of a plan wind up. The purpose of the Pension Benefits Guarantee Fund (PBGF) is to guarantee payment of certain benefits in respect of service in Ontario where the employer is insolvent. The PGBF is funded by assessments on employers sponsoring defined benefit plans. The Ontario Superintendent of Financial Services (Superintendent) is responsible for the administration of the PBGF.

If certain conditions are satisfied, the Superintendent may declare that the PBGF applies to a particular pension plan. First, the plan must be registered in Ontario or a designated province. Second, the plan must provide defined benefits which are not exempt from the PBGF. Third, the pension plan must be wound up in whole or in part. Finally, the Superintendent must be of the opinion, based on reasonable and probable grounds, that the funding requirements of the PBA and its regulations cannot be satisfied.

Where money is paid out of the PBGF as a result of a wind up, the Superintendent has a lien and charge on the assets of the employer who sponsored the pension plan in an amount equal to the payment out of the fund, plus interest.

Pension Plan Investments

The investments of Canadian pension plans must comply with the investment rules under applicable pension legislation. Generally, these rules stipulate diversification standards and other quantitative limits. Qualitative constraints are reduced to a test of prudent portfolio risk, which must be set out in a SIP&P. The ITA also imposes rules relating to foreign investments made by pension plans. The foreign property rules under the ITA currently limit pension fund investments in foreign property to thirty percent of the book value of the total fund. Investments in excess of this limit trigger a one percent per month penalty tax. Many pension plans consider the use of derivative financial products to avoid the penalty tax.

Business Reorganizations

When a Canadian corporation is being sold, pension issues can be of significant concern. The vendor and purchaser must consider the effect of the transaction on the rights and interests of pension members. Depending on whether the transaction contemplates the sale of assets or shares, the parties may be required to negotiate specific terms in the agreement of purchase and sale dealing with pension plans covering employees affected by the transaction.

Pension legislation protects certain rights of transferred employees upon the sale of a business. It preserves entitlement to the employees' benefits accrued to the closing date and recognizes service with both the vendor and the purchaser in determining eligibility for, and vesting of, benefits under both the vendor's pension plan and the purchaser's plan.

Most pension legislation deems the employment of a transferred employee to be continuous on the sale of a business. As a result, a sale typically does not trigger the termination provisions of the vendor's pension plan which entitle employees to portability rights (*i.e.*, rights to transfer benefits out of the pension plan to locked-in retirement arrangements).

If a purchaser assumes the responsibility for the benefits of the transferred employees accrued to the closing date, pension legislation provides that no transfer of assets from the vendor's pension plan to the purchaser's plan can occur without the prior consent of the pension regulatory authority. Such prior approval to the transfer allows the regulatory authority to oversee the protection of the members' pensions and other benefits.

Pension Litigation - Class Actions

While there is generally less litigation in Canada than in the United States, litigation in the pension field is on the rise in Canada. This is the result of a number of factors, principally the recent introduction of legislation permitting class actions. The availability of the class action has prompted a number of actions to be brought on behalf of all pension plan members which, in the past, would not have been brought as they were uneconomic or too difficult for one member of a pension plan to bring.

The claims that are typically advanced in Canadian pension litigation involve: the interpretation of members' rights under the pension plan documentation, including rights to surplus in the pension plan; allegations of misrepresentation arising out of pension plan communications; or allegations of breach of fiduciary duty or breach of trust made against the administrator and/or the trustee of the pension fund.

McMillan Binch LLP has expertise and experience in handling all types of pension litigation and in fact represented the pension plan sponsor in the first pension class action in Ontario.

Group RRSPs – A Pension Alternative

Canadian employees also save towards retirement through registered retirement savings plans (RRSPs), which are similar to 401(k) plans in the United States.

Many Canadian employers maintain group RRSP arrangements for their employees in addition to, or in place of, pension plans. Each employee who is a member of a group RRSP pays his or her contributions into a single trust. The contributions and investment earnings of each member are kept separate, usually by establishing separate accounts for each member within the group RRSP.

Employer contributions to the RRSP are treated as a taxable benefit to the employee. Employer contributions are typically established as a percentage of the employee's own contribution. An employee is entitled to deduct employer and employee group RRSP contributions from his or her income for tax purposes, subject to a maximum annual contribution limit. The limit is currently the lesser of eighteen percent of the previous year's earned income and C$14,500. Employees can carryover unused contribution room from year to year.

The main advantage of providing a group RRSP instead of a pension plan is that group RRSPs are not subject to pension legislation and have less onerous reporting and administrative requirements.

McMillan Binch llp Experience

McMillan Binch LLP has significant expertise in assisting US companies in establishing and administering Canadian pension and other retirement plans. For specific advice regarding any of the issues raised in this bulletin, please contact one of the lawyers listed below.

For further information, please contact any of the following members of the McMillan Binch LLP Pensions and Employee Compensation Group:

David Wentzell	416.865.7036	david.wentzell@mcmillanbinch.com
Susan Nickerson	416.865.7239	susan.nickerson@mcmillanbinch.com
Hilary Clarke	416.865.7286	hilary.clarke@mcmillanbinch.com
Ivan Luksic	416.867.7923	ivan.luksic@mcmillanbinch.com

McMillan Binch llp

Telephone: 416.865.7000
Facsimile: 416.865.7048
Web: www.mcmillanbinch.com

BCE Place, Suite 4400, Bay Wellington Tower, 181 Bay Street, Toronto, Ontario, Canada M5J 2T3